United States Court of Appeals

for the

District of Columbia Circuit

TRANSCRIPT OF RECORD

856

No. 23,987

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FIDUCIARY COUNSEL, INC.,

Appellant

v.

JAMES D. HODGSON,
SECRETARY OF LABOR,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

APPENDIX PREPARED BY THE APPELLEE
PURSUANT TO LEAVE OF COURT

United States Court of Appeals
for the District of Columbia Circuit

FILED AUG 14 1970

Nathan J. Paulson
CLERK

C O N T E N T S

page

Ex. 4

EXEMPTIONS FROM THE BONDING REQUIREMENTS OF THE WELFARE AND PENSION PLANS DISCLOSURE ACT

29 CFR PART 464

BANKS, TRUST COMPANIES, INVESTMENT ADVISERS

Prepared by the Office of the Solicitor, Unites States Department of Labor

August 12, 1968

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EXHIBITS

Exhibit No. A-1 - Federal Deposit Insurance Corporation 1966 Annual Report, Table 103 pp. 132-133; Table 121, p. 184; and Table 122 p. 185, and The Comptroller's Statistical Supplement to the 1966 Annual Report, Table B-21, p. 150. These tables are referred to in various footnotes in Part I of the written submission.

Exhibit No. A-2 - A chart illustrating the Federal and state governmental supervision of banks and trust companies. This chart is presented to depict the broad range of activities subject to the supervision of these governmental authorities.

Exhibit No. A-3 - Comptrollers Manual for National Banks Laws, Regulations and Rulings. This Manual is a compilation of all statutes, regulations and rulings governing national banks. It is submitted to serve as a reference guide for the statutory and regulatory material concerning the scope of supervision exercised by the Comptroller over National banks.

Exhibit No. A-4 - The Comptroller of the Currency's Instructions, Procedures, and Forms for National Bank Examiners. This compilation consists of instructions for bank examiners, detailed procedures which the examiners are to follow, and worksheets and checklists for all phases of a bank examination. This exhibit is being presented to illustrate the detailed procedures employed by national bank examiners in conducting an examination, and to serve as a reference for materials discussed in the written submission.

Exhibit No. A-5 - Comptrollers Manual for Representatives in Trusts. This manual contains detailed material concerning examinations of the trust departments of national banks. The exhibits being presented to illustrate the detailed procedures employed by national bank examiners concerned with the scrutiny of trust departments, and as a reference for the material discussed in the written submission, Part I.

Exhibit No. A-6 - The Federal Reserve Act - This is being submitted as a reference to the statutory material cited in

the discussion of the scope of supervision of state member banks by the Fed.

Exhibit No. A-7 - Application Form for Membership in the Federal Reserve System for state banks except mutual savings banks. This application is being presented to illustrate the close scrutiny the Fed. exercises in accepting new banks for membership in the system.

Exhibit No. A-8 - The American Bankers Association, Insurance and Protective Committee's (a) table of minimum bonding stan- dards; (b) listing of different forms of bank insurance and other coverages; (c) comparison of different forms in blanket bonds; and (d) illustrative chart of blanket bond coverage in each deposit size range as of 1959. This material is from the Digest of Bank Insurance, published by the Committee, and submitted to elaborate on the material presented in Part I (E) of the written submission.

Exhibit No. A-9 - The Federal Deposit Insurance Act. This Act defines the authority of the F.D.I.C. as to insured banks. It is being submitted for reference purposes, for the statu- tory material concerning its activities in the written sub- mission.

Exhibit No. A-10 - State Banking - A compendium compiled by the state bank division of the American Bankers Association. This compilation contains material on all phases of state bank supervision and is submitted as a reference for the material presented in Part II of the written submission.

Exhibit No. A-11 - A compilation of state bonding requirements. These statutes are an elaboration of the material on state bonding requirements presented in Part II of the written sub- mission. Includes citations to state examination requirements.

Exhibit No. A-12 - Comparative Regulations of Financial Institutions, Subcommittee Print, Committee on Domestic Finance, House Committee on Banking and Currency, 88 Cong., U. S. Government Printing Office, 1963, Table 3, p. 260. This table is to be used for reference in conjunction with the material on state supervision of banks in Part II of the written submission.

Exhibit No. A-13 - The Investment Advisers Act of 1940, and General Rules and Regulations pursuant thereto. This is submitted as a reference to Part I of the written submission which deals with the regulation of investment advisers.

Exhibit No. A-14 - Application for Registration as an Investment Adviser with the Securities and Exchange Commission. This is submitted to illustrate the degree of supervision exercised over investment advisers by the S.E.C.

Exhibit No. A-15 - "Is Your Financial Blanket Bond Coverage Adequate?", Lester A. Pratt, a reprint from Banking, the American Bankers Association Journal. This reprint is referred to in footnote 221 in Part I , and contains general explanatory material concerning the A.B.A. minimum bonding criteria.

Introduction

This written submission constitutes an elaboration of factual material on the regulation of banks and trust companies by federal and state agencies, and the regulation of investment advisers by the Securities and Exchange Commission. It is being submitted to aid the Secretary in his reevaluation of the exemption from the bonding requirements of the Welfare and Pension Plans Disclosure Act, (WPPDA), 29 U.S.C. 308d, granted to federally and state regulated banks and trust companies in 29 CFR 464.4(c)(1), but denied to investment advisers registered with the Securities and Exchange Commission.

The submission examines in detail the scope of federal supervision of banks and trust companies exercised by the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. A similar study is presented concerning the scope of state supervision of bank and trust companies. Finally the submission discusses the scope of regulation of investment advisers under the Investment Advisers' Act of 1940, and regulations promulgated pursuant thereto by the Securities and Exchange Commission. Federal regulation of investment advisers is then compared with federal and state regulation of banks and trust companies.

This reevaluation was precipitated by litigation involving the Secretary and Fiduciary Counsel Inc., an investment adviser registered with the Securities and Exchange Commission, in which the latter contended *inter alia* that it was entitled to an exemption from the WPPDA bonding requirements. The District Court in *Fiduciary Counsel Inc. v. Wirtz*, 63 LRRM 2500, 54 L.C. ¶11,565 (D.C.D.C. 1966), did not specifically rule on this assertion; the Court of Appeals, 383 F.2d 203 (1967), however, reversed, and remanded the case to the District Court with specific instructions to consider the issue of whether the Secretary's regulation, exempting from the bonding requirements certain federally and state regulated banks but not investment advisers registered with the Securities and Exchange Commission, was reasonable. Thereafter, Fiduciary Counsel Inc. renewed its petition for an exemption. In the light of these factors, the Secretary determined that a rule-making hearing should be conducted to amass all relevant facts on the appropriateness of the present bonding exemption, as well as the appropriateness of extending an exemption to investment advisers. This material is submitted to assist in this purpose.

I. SCOPE OF FEDERAL SUPERVISION OF BANKING INSTITUTIONS

I. SCOPE OF FEDERAL SUPERVISION OF BANKING INSTITUTIONS

A. Federal Supervision in General

Governmental supervision of banks and trust companies is derived from four sources. At the federal level, regulation is vested in three agencies, the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation. As of December 31, 1966, 13,873 commercial banks out of a total of 14,291 were subject to regulation by at least one of these three agencies.1/ In addition, banks subject to supervision by the Federal Reserve System (hereafter referred to as The Fed.) and the Federal Deposit Insurance Corporation (hereinafter referred to as F.D.I.C.) are also subject to the control of the banking agencies of the fifty states.2/

The fundamental function of bank supervision on the federal and state level is to limit the risk of bank failure, e.g., the risk that the value of bank assets may fall below the amount of its liabilities. There are three basic methods by which this control of the risk of failure is maintained. The first is by exercising an influence over the respective portions of a bank's funds which represent equity and which represent debt;3/ the second is control of the quality of assets held by the banks;4/ and the final method is the maintenance of high quality bank management.

B. Supervision by the Comptroller of the Currency

The Comptroller of the Currency (hereinafter referred to as the Comptroller) is a bureau within the Department of the Treasury, and is charged with exercising supervisory powers and issuing regulations relating to national banks. The broad scope of supervision exercised by the Comptroller includes the chartering of national banks; granting trust powers; issuing and requiring adherence to regulations pertaining to banking operations and procedures; requiring and receiving information and reports; requiring the correction of unsafe and unsound banking policies; and performing examining functions as to national banks.5/

1/ Federal Deposit Insurance Corporation (F.D.I.C.) 1966 Annual Report, submitted in this Hearing as Exhibit No. A-1, Table 103, pp. 132-133.

2/ See Exhibit No. A-2 - A chart of federal and state government supervision of banks.

3/ "Some Problems of Bank Supervision," Homer Jones, Reprinted from the Journal of the American Statistical Association, Vol. 33, 1938, pp. 695-706.

4/ Ibid., See also 12 U.S.C. 53.

5/ Jones, Adrian, "History and Development of Governmental Supervision of Banks" - A doctoral thesis, 1964, p. 20.

Any number of natural persons, not less than five, who have entered into an association to carry on the business of banking can apply to the Comptroller for a charter to operate a national bank.6/ The articles of association must specify in general terms the object for which the association has been formed, and may contain any other provisions not inconsistent with law.7/ These persons also draw up an organizational certificate, which must specifically state:

> First. The name assumed by such association; which name shall include the word "national" and be subject to the approval of the Comptroller of the Currency.
>
> Second. The place where its operations of discount and deposit are to be carried on, designating the State, Territory, or District, and the particular county and city, town, or village.
>
> Third. The amount of capital stock and the number of shares into which the same is to be divided.
>
> Fourth. The names and places of residence of the shareholders and the number of shares held by each of them.
>
> Fifth. The fact that the certificate is made to enable such persons to avail themselves of the advantages of this Title.8/

The factors which the Comptroller must consider in his decision as to whether to approve such an application are not specifically enumerated. He must determine, however, that the bank is organized in accordance with the provisions of the banking laws, specifically that the requirements as to capitalization, name, organizers and fixed assets are met. In addition, since every national bank automatically becomes a member of The Fed., and insured by the F.D.I.C., the Comptroller must consider the factors required for coverage by these agencies.9/

The Comptroller has authority, pursuant to 12 U.S.C. 35 to convert any bank incorporated by special law of any state, or of the United States, into a national banking association. To qualify, such a bank must have an unimpaired capital sufficient to entitle it to become a national banking

6/ 12 U.S.C. 21 (R.S. 5133).

7/ Ibid.

8/ 12 U.S.C. 22.

9/ These factors will be discussed in detail in a subsequent portion of this submission.

association under the provisions of existing laws,10/ and must have the approval of the shareholders of not less than 51 percent of the capital stock of this bank.

There are stringent minimum capital and paid in surplus requirements that a national banking association must fulfill. 12 U.S.C. 51 requires a national bank to be organized with a minimum capital of $100,000, with the following specified exceptions:

(a) If the population of the place in which the bank is organized does not exceed 6,000 persons, the bank's capital must be at least $50,000:

(b) if the population exceeds 50,000 persons, the minimum capital requirement is $200,000; however,

(c) in the outlying districts of such a city, a national bank may be organized with a minimum capital of $100,000 with the approval of the Comptroller of the Currency, if state laws permit the organization of state banks with a capital of $100,000 or less. In addition, before a national bank will be authorized to do business, all of its capital stock must be paid in.11/

12 U.S.C. 51 provides that as a general rule, a national bank will not be authorized to commence doing business unless it has a paid-in surplus equal to twenty percent of its capital. This twenty percent requirement is intended to provide some insurance of continued solvency of national banks.12/ The paid-in surplus requirement may be waived by the Comptroller in the case of a state bank converting into a national bank where the following conditions have been met. The state bank must, before declaring a dividend on its common stock, carry at least one-half of its net profits for the preceding half year to a surplus fund until it has a surplus equal to twenty percent of its capital. Any sums which a converted bank pays out of its net earnings for such a half-year period into a fund for the retirement of its preferred stock will be considered an addition to the surplus fund upon the retirement of the preferred stock.13/

The capital stock of national banks must have a par value of $100 per share unless the articles of association provide for a lesser par value.14/ The negotiability of national bank stock is controlled by

10/ See 12 U.S.C. 51(a).

11/ 1 CCH Fed. Bank. Rep., paragraph 5551.

12/ Ibid.

13/ Ibid.

14/ 12 U.S.C. 52.

federal law, although state statutes may govern questions concerning the legal capacity of specific persons to make a transfer.15/ National banks may increase their capital stock either by sale of new common stock for cash, or by a declaration of a stock dividend. In either case, this increase must be approved by (a) a vote of the owners of two-thirds of the bank stock, and (b) the Comptroller.16/ Where a stock dividend is declared, the paid-in surplus of the bank must equal at least twenty percent of the capital stock as increased.17/ A national bank may reduce its capital stock according to the same general procedure; however, the amount of capital stock must never fall below the sum required to authorize its formation.18/

The Comptroller has far-reaching authority over all phases of the exercise of trust powers by a national bank. He is empowered to grant, by special permit upon application by a national bank (when this application is not in contravention to any state law), "the right to act in a fiduciary capacity in which state banks, trust companies, or other corporations which are in competition with national banks are permitted to act under the laws of the state in which the national bank is located."19/

In passing upon the application to exercise fiduciary powers, the Comptroller is required (by the fiduciary regulation)20/ to give consideration to the following matters:

(a) Whether the bank has sufficient capital and surplus to exercise the fiduciary powers applied for, which capital and surplus in no case shall be less than that required by state law of state banks, or other institutions exercising such powers;

(b) The needs of the community for fiduciary services and the probable volume of such fiduciary business available to the bank;

(c) The general condition of the bank, including the adequacy of its capital and surplus in relation to the character and condition of its assets and to its deposit liabilities and other corporate responsibilities, including the exercise of fiduciary powers;

(d) The general character and ability of the management of the bank;

(e) The nature of the supervision to be given to the fiduciary

15/ 1 CCH Fed. Bank. Rep., paragraph 5555.

16/ 12 U.S.C. 57.

17/ Ibid.

18/ 12 U.S.C. 59.

19/ 12 U.S.C. 92(a).

20/ 12 CFR Part 9.

activities, including the qualifications, experience and character of the proposed officer or officers of the trust department.

(f) Whether the bank has available legal counsel to advise and pass upon fiduciary matters wherever necessary.21/

These factors are separate and apart from those examined upon application for a charter to become a national bank.

The Comptroller places the primary responsibility for the proper exercise of the fiduciary powers of a national bank on the board of directors.22/ No fiduciary account is to be accepted without the prior approval of the board of directors or their designees, and a written record must be maintained of all such acceptances and relinquishments.23/ The board shall also insure that there is a periodic review of each fiduciary account in which the bank has investment responsibilities to determine the advisability of retaining, or disposing of these assets.24/ All officers and employees participating in the operation of the trust department are required to be adequately bonded.25/ In addition, legal counsel is to be retained to pass upon fiduciary matters and advise the trust department.

The books and records of such institutions are required to be kept separately from all other bank records, and to contain full information relative to each account. This information is to enable the bank in question to furnish the Comptroller any information he desires. These records must include an up to date account of all pending litigation.26/

A committee of directors is required to conduct an audit of the trust department at least once during each calendar year and within fifteen months of the last audit, or cause such an audit to be made by outside auditors responsible only to them.27/ This audit is specifically intended to reveal whether the trust department of the bank has been operating in accordance with the banking laws, regulations pursuant to it,

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21/ 12 CFR paragraph 9.3.

22/ 12 CFR paragraph 9.7.

23/ *Ibid.*

24/ *Ibid.*

25/ *Ibid.* It is not made clear whether this is an additional bonding requirement, over and above the requirement that all national bank employees must be bonded.

26/ 12 CFR 9.8, 12 U.S.C. 92(a).

27/ 12 CFR 9.9.

and sound fiduciary principles. A continuous audit system is an acceptable alternative to the above requirements.

The investments in each account are to be kept separate from the general assets of the bank, and placed in the joint custody of not less than two of the bank's officers or employees who are so designated. Each account must be kept separate from those of all other accounts except in the case of collective investments, or otherwise adequately identified as the property of the particular account.28/

Funds held by a national bank in a fiduciary capacity are required to be invested in accordance with the instrument establishing the fiduciary relationship and local law. As part of the examination of a trust department of a national bank, the Comptroller examines the investments held by this bank as a fiduciary to determine whether they have been made in accordance with law and sound fiduciary principles. Any discretion in investments is governed by the terms of the trust agreement, and applicable local law. Self-dealing in any form by the directors, officers or employees is forbidden.29/

The trust regulation, 12 CFR Part 9, formulates specific procedures to be followed with respect to funds held in a fiduciary capacity awaiting investment or distribution. Such funds are not to be kept uninvested, or undistributed any longer than is reasonably necessary for the proper management of the account. They may be deposited in the commercial, savings, or other department of the bank (in the absence of any prohibition by local law, or in the trust agreement) only if there is first set aside under the control of the trust department as collateral security the following:

(1) Direct obligations of the United States, or other obligations fully guaranteed by the United States as to principal and interest; or

(2) Readily marketable securities of the classes in which state banks exercising fiduciary powers are authorized or permitted to invest trust funds under the laws of the state in which such national bank is located; or

(3) Other readily marketable securities that qualify as investment securities pursuant to the Investment Securities Regulation of the Comptroller of the Currency (12 CFR 1).

28/ 12 CFR 9.13.

29/ 12 CFR 9.11-9.12.

these securities must at all times be at least equal in value to the amount of the uninvested trust funds.30/

12 U.S.C. 92(a), and the detailed regulations issued pursuant to it enumerate strict standards governing the organization and operations of a trust department in national banks. These departments are in a sense treated as separate institutions, required to comply with regulations not imposed upon the other departments of national banks. These requirements are enforced through periodic examination of these departments by the Comptroller, and through reports that are required to be filed with the Comptroller. They are intended to maintain uniformly high standards in the conduct of fiduciary activities by national banks and to minimize the possibility of loss to these accounts through mismanagement, fraud, or embezzlement.

An important phase in the supervision of national banks is the requirement that these institutions submit periodic reports of condition to the Comptroller. A national banking association is required to submit not less than three reports of condition each year to the Comptroller on forms prescribed by him.31/ The Comptroller is additionally empowered to call for special reports whenever he believes they are necessary to properly perform his supervisory functions under the banking laws. Every report shall set forth in detail the assets and liabilities of the association as of the close of the date he specifies. It must be transmitted to the Comptroller within 10 days after receipt of a request for the report (receipt of call).

These reports must be signed by the president or cashier, and their correctness attested by the signatures of not less than three directors other than the signing officer.32/ In an emergency, when the required signers are not available, the Comptroller is empowered to accept substitutes.

In addition, each association is required to submit periodic reports of the payment of dividends, including advance reports of dividends proposed to be declared or paid.33/

Each national banking association is required to obtain from any affiliate other than member (of the Federal Reserve) banks not less than four reports per year. These reports contain information necessary to fully disclose the relations between the affiliate and the bank so that the Comptroller can determine the effect of these relations upon the

30/ 12 CFR 9.10.

31/ 12 U.S.C. 161.

32/ *Ibid.*

33/ *Ibid.*

affairs of the bank. They are to be submitted to the Comptroller at the same time as the corresponding report of the association.34/

The purpose of requiring these reports is to insure that there will be a prompt discovery of violations of the banking laws. To effectuate this purpose, in addition to being submitted to the Comptroller, the statement of resources and liabilities contained in the report is published in a newspaper published in the place where the association is established.35/ This publication furnishes information to all persons having, or contemplating business transactions with such associations into which the condition of the bank enters as a material factor. The affiliate report referred to above is also published in accordance with this procedure.

The bank call report is very similar to the annual financial report required by WPPDA section 7. It is intended to serve the same basic purpose, to disclose to the regulatory authority and persons affected by the operations of these associations the financial operations for the period covered. The persons charged with the duty of compiling the call reports are in positions of authority similar to WPPDA plan administrators. The requirement that the correctness of these reports be attested to is analogous to the WPPDA section 7 mandate that the "information required by this section shall be sworn to by the administrator, or certified by an independent public accountant . . . after a comprehensive audit." The publication in a newspaper obligation is comparable with the WPPDA provision that the financial reports shall be made available to plan participants and beneficiaries at the plan's principal office.

Section 7 of the WPPDA is intended to accomplish a basic supervisory function, insuring a high level of managerial competency by providing full disclosure of the plan's financial operations to its participants. The call reports perform the same basic function; however, they serve an additional supervisory purpose. Unlike welfare and pension plans, national banking associations are required by law and regulation, to comply with specific operational procedures, e.g., issuance of capital stock, minimum capital levels, and trust department procedures. In addition, these associations are forbidden to engage in certain practices, e.g., making specific types of loans.36/ The call reports provide the Comptroller with the necessary information to determine whether the associations are in fact adhering to the provisions of the federal banking laws.

The call reports permit the Comptroller to exercise a closer degree of supervision over national banks than the WPPDA financial reports permit the Secretary to exercise over welfare and pension plans. The former

34/ 3 CCH Fed. Bank. Rep. paragraph 59,401.

35/ Ibid.

36/ 12 U.S.C. 481.

not only provides full disclosure of the activities of the banks, but are specifically geared to reveal possible violations of law, or regulations pursuant thereto. The Comptroller is empowered to ask for whatever information he deems necessary whenever he believes that this additional information will aid him in administering these federal banking laws. The latter report is limited to a disclosure (with some exceptions) of the basic financial operations of the plan. It is not geared to enable the Seceretary to regulate the operations of welfare and pension plans because the WPPDA is basically a disclosure rather than a regulatory statute. The laws governing national banks, on the other hand, are regulatory in nature, and the call report requirement is a basic part of this regulatory scheme.

The most important supervisory function performed by Comptroller of the Currency is the periodic surprise examination of national banking associations. Every national banking association must be examined twice in each calendar year by an examiner appointed by the Comptroller. One such examination may be waived, or more frequent examinations may be provided for when considered necessary. However, the Comptroller's authority to waive examinations is limited in that the waiver cannot be granted more frequently than once every two years. Thus, every national bank is examined a minimum of three times every two years.37/

The examiners are empowered to delve into all of the affairs of a bank, including (a) to examine its officers and agents; (b) examine the affairs of non-member affiliates as deeply as necessary to disclose the effect of these relationships on the affairs of the national bank; (c) examine the cash, collateral, and all negotiable securities held in the bank; (d) examine loans made and discounts given and; (e) scrutinize notes held by the bank for their genuineness.38/ The scope of an examination may embrace every phase of banking activity found in the particular bank under examination, or it may concentrate in specific areas of bank activity. The basic purpose of this examination is to determine the present and prospective liquidity and solvency of the institution in question, and the legality of its acts.

The Comptroller provides national bank examiners with detailed instructions, procedures and forms (Exhibit A-4) upon which to base their examinations. Every phase of the bank's operation are included in these forms, and specific procedures are provided for each portion of the examination. For example, all loans and discounts must be listed and compared with the bank's general ledger. Where the bank is using automation techniques, the machine copies are to be obtained and checked against the examiner's list.39/

37/ 12 U.S.C. 481.

38/ Ibid.

39/ Exhibit No. A-4, Comptroller's Instructions, Procedures and Forms for National Bank Examiners, p. 14.

Every type of collateral security is to be listed on the proper forms and compared with the bank's listings.40/ The entire internal controls system of the bank is examined by comparing the system in the particular bank with a master check list.41/ The master check list represents the proper internal controls that each national bank should maintain.

After the actual examination is conducted, the examiners appraise all of the information gathered and formulate a report to the Comptroller. This appraisal is to determine the specific areas, if any, where the bank's operation can be improved. Where the examiner finds specific weaknesses, i.e., an unwise loan, he presents a written criticism of these weaknesses and recommendations as to how they can be corrected. He also brings to the attention of the bank's directorate and executive management any violations fo the federal banking laws which he believes to have occurred. He indicates the specific area in which the violation occurred, the section of the statute, or regulation violated, and the reason why the activity is improper. The recommendations the bank examiner makes concern specific inadequacies.

The trust departments of national banks are examined as separate entities by examiners who specialize in this type of examination. As above, the examination covers all phases of the operation of the trust department, and is geared to determine (a) whether the department is functioning in accordance with the statutes governing national banks, and the rules and regulations in 12 CFR Part 9; (b) whether all the assets can be accounted for; (c) whether all the books and records are complete and up to date; (d) whether selected fiduciary accounts are being managed in accordance with the terms of the trust agreement; and applicable law; and (e) whether the trust department is functioning according to accepted fiduciary standards. The internal controls exercised over the operations of this department are closely scrutinized.42/ Auditing practices, control of specific accounts, adequacy of account records, and soundness of investment policies are studied and evaluated to the Comptroller and the directorate and executive management of the bank. Any improper practices, including conflict of interests, self-dealing, and improper investments, are also reported to the Comptroller and the bank, and steps are immediately taken to remedy them.

The examiner submits a full report to the Comptroller of his findings in the examination of the bank which includes the trust department examination. The reports outline in detail the problem areas in the particular institution, any violations of law or regulations, and any unwise managerial practices or lack of sufficient internal controls. The Comptroller, upon

40/ *Ibid.*, pp. 21, 25, 47-49. See Exhibit No. A-4.

41/ *Ibid.*, pp. 61-63. See Exhibit No. A-4.

42/ Exhibit No. A-5, Comptrollers Manual for Representatives in Trust, pp. 45 *et seq.* This manual contains instructions, worksheets, and forms which are used in the examination of trust departments of national banks.

study of these reports, makes specific recommendations. If the particular institution fails to permit an examination, its charter is subject to revocation.43/ If the bank management fails to correct violations of law or regulations, or fails to adopt specific recommendations of the Comptroller or examiner, its charter is also subject to revocation. Where the examiner finds specific problems in a particular institution, subsequent examinations focus on these areas to determine if the necessary corrections have been made.

The examination procedure provides a constant check on the assets, internal controls, and managerial policies of national banking associations. The trust departments of these banks are closely scrutinized to determine that they are carrying out their fiduciary functions in accordance with federal and state law, and where applicable, the terms of the individual trust agreements. A measure of the effectiveness of examination procedure, as well as the other elements of supervision exercised over national banks, is that in 1966, out of a total of 4,799 national banks with assets totaling $235 billion, 996 million, only two national banks with assets totaling about $2 million closed because of financial difficulties.44/ Neither of the two banks involved operated trust departments.45/

In addition to all of the other elements of governmental supervision exercised over national banks, the Comptroller of the Currency requires bonding of all officers and employees of national banking associations. A Comptroller's ruling provides:

> All officers and employees of a national bank must (emphasis added) have adequate fidelity coverage, and the failure of Directors to require bonds with adequate sureties and in sufficient amount may make them liable for any losses which the bank sustains because of the absence of such bonds. Directors should not serve as sureties on such bonds.
>
> The Board of Directors should determine the amount of such coverage, premised on such factors as (1) internal auditing safeguards employed, (2) number of employees, (3) amount of deposit liabilities, and (4) amount of cash and securities normally held by the bank, among others.46/

43/ 12 U.S.C. 481

44/ See Exhibit No. A-1, Table 121 and 122, pp. 184-185, also containing Table B-21, (p. 150) of the Comptroller's Statistical Supplement to the 1966 Annual Report.

45/ According to an interview with the F.D.I.C., no bank that failed during 1966 contained trust departments.

46/ 3 CCH Fed. Bank. Rep. paragraph 59,816.

The Comptroller reviews the adequacy of fidelity coverage as part of each bank examination. The bank examiner scrutinizes the base amount of coverage, the excess employee liability coverage (which covers internal losses only), and the scope of coverage.47/ Those factors are weighed against the criteria listed above to determine whether the fidelity coverage meets reasonable protective standards. The Comptroller will order additional bonding if he feels that the present coverage is inadequate. It appears that the minimum standards required are those formulated by the American Bankers' Association Insurance and Protective Committee.48/

47/ Supra note 39 at p. 71. See Exhibit No. A-4.

48/ The chart setting forth the minimum standards is marked Exhibit No. A-8. The Committee recommends coverage far in excess of these statutory minimums. The F.D.I.C. uses the findings of this Committee, as published in the Digest of Bank Insurance, as general guidelines as to the scope and amount of fidelity coverage to be required of its insured banks.

C. Supervision by The Federal Reserve System

The scope of governmental supervision under the Federal Reserve System is basically the same as that exercised by the Comptroller. The system is supervised by a Board of Governors, the Federal Reserve Board (hereinafter referred to as The Fed.). The country is divided into twelve districts, with a Federal Reserve bank being established in each of these districts. The individual banks which are part of this system are called "member banks." There are two classifications of banks which join the system, (a) national banks, which by statute must become members of the system; and (b) state banks, which are chartered by their states, and join the system voluntarily. Each of the twelve Federal Reserve banks has been delegated the primary responsibility of supervising the member banks within their district.

Any bank incorporated by special law of any state, or organized under the general laws of any state or of the United States which desires membership in the Federal Reserve System may make application to the Board of Governors. 49/ In ruling upon applications, the Board of Governors must consider:

(a) the financial history and condition of the applying bank and the general character of its management;

(b) the adequacy of its capital structure in relation to the character and condition of its assets and to existing and prospective deposit liabilities and other corporate responsibilities, and its future earnings prospects;

(c) the convenience and needs of the community to be served by the bank; and

(d) whether its corporate powers are consistent with the Federal Reserve Act. 50/

These factors are a test of the applicant's initial solvency, level of managerial skill, and standards of operation. The application form requires that exhibits be submitted 51/ which set forth the type of business engaged in by the bank, its corporate powers, and the results of the latest examination and call reports. Unlike the national banks, the corporate powers of those banks are derived from their state laws; thus, The Fed. does not enumerate the type of powers that can be exercised by member banks.

49/ Federal Reserve Act, section 9. The Act is submitted in this hearing as Exhibit No. A-6.

50/ Ibid. See sections 9(4), 9(11). See also 2 CCH Fed. Bank Rep. paragraph 35,265.

51/ Exhibit No. A-7, Application Form for State Banks applying for membership in The Fed.

However, the application does afford The Fed. the opportunity to determine whether these corporate powers are consistent with the policies expressed under the Federal Reserve Act.

As in the case of national banks, The Fed. has minimum capital requirements which must be met for admission into the system. Since all national banks are required to become members of the Federal Reserve System, the minimum capital requirements (discussed previously) governing the organization of new national banks are deemed satisfactory for membership in the Federal Reserve System. For a state bank other than a mutual savings bank to be admitted to membership, it must have capital stock and paid in surplus which in the judgment of the Federal Reserve Board are adequate in relation to its assets, deposit liabilities, and other corporate responsibilities. These banks, with few exceptions, must meet minimum capital requirements provided for national banks in the same community. In the alternative, the applying bank must be, or have been approved for deposit insurance under the Federal Deposit Insurance Corporation's requirements for approving applications for insurance. 52/ If The Fed. considers a bank's capital and surplus funds insufficient at any particular time, it may order an increase in such funds to a level they consider adequate.

Mutual savings banks may become members of the Federal Reserve System if they possess surplus capital and undivided profits in an amount equal to that required for the organization of a national bank. If state law does not permit mutual savings banks to invest in any stock (which would include Federal Reserve Bank Stock), the bank may submit to The Fed. an amount of stock equal to the stock that the bank would have been required to purchase if state law had permitted this purchase. (See discussion below). However, a mutual savings bank must eventually purchase stock in The Fed. bank of its district, or lose its membership.

In addition to the minimum capital and surplus requirements, each member bank is required to subscribe to specified amounts of capital stock of its Federal Reserve bank. Each bank must subscribe to this capital stock in an amount equal to six percent of the paid-up capital stock and surplus of this member bank at the time of application. 53/ When a member bank increases its capital stock or surplus, it must immediately subscribe for an additional amount of capital stock in the Federal Reserve bank equal to six per cent of the increase. When a member bank reduces its capital stock or surplus it must surrender a proportionate amount of its holdings

52/ Federal Reserve Act, section 9(11).

53/ Federal Reserve Act, section 5.

in the Federal Reserve bank.54/ Any Federal Reserve stock in excess of six per cent must be surrendered. This stock is not transferable, nor can it be pledged.55/

The Fed. also imposes reserve requirements which member banks must maintain on deposit with the Federal Reserve bank of their district. This reserve requirement consists of:

> "an actual net balance equal to three per cent of its time deposits, plus 7 per cent of its net demand deposits if it is not located in a reserve city or 10 per cent of its net demand deposits if it is located in a reserve city, or such different percentages of its time deposits and net demand deposits as the Board of Governors of the Federal Reserve System, pursuant to and within the limitations of section 19 of the Federal Reserve Act may prescribe from time to time."56/

A member bank located in a reserve city may maintain reserve balances in an amount equal to that required of member banks located in a non-reserve city if The Fed. grants permission for such a lower amount. The Fed. will grant permission after considering all of the factors relating to the character of the bank's business including (a) the amount of total assets; (b) the amount of total demand deposits; (c) the nature of its depositors and borrowers; and (d) the rate of activity of its demand deposits.57/ This permission is subject to revocation by The Fed. at any time, and is subject to annual review to determine to what extent these conditions have changed.

Deficiencies in reserve balances of member banks are computed on a daily basis, and penalties are assessed monthly on the basis of average daily deficiencies.58/ In addition, whenever it appears that a member bank is not paying sufficient attention to the maintenance of its reserves, the Federal Reserve bank in question is required to contact by letter each director of this bank, calling his attention to this situation and advising him of the requirements with regard to the maintenance of reserves.59/ If the member bank continues to permit deficiencies in reserves to occur, the Federal Reserve bank must report this fact to The Fed. with a recommendation as to whether or not they should:

> "(1) In the case of a national bank, direct the Comptroller of the Currency to bring suit to forfeit the charter of such national bank pursuant to section 2 of the Federal Reserve Act

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54/ Ibid.

55/ Ibid.

56/ 12 C.F.R. 204.2

57/ Ibid.

58/ 12 C.F.R. 204.3

59/ Ibid.

> (2) In the case of a state member bank, institute proceedings to require such bank to surrender its stock in the Federal Reserve bank and to forfeit all rights and privileges of membership pursuant to section 9 of the Federal Reserve Act.
>
> (3) In either case, take such other action as the Federal Reserve bank may recommend or the Board of Governors of the Federal Reserve System may consider advisable."60/

These reserve requirements perform an important function in insuring that its member banks remain solvent, able to meet their obligations as they arise. Their basic function is to provide a basis for monetary regulation,61/ but they have the residual effect of aiding in the maintenance of member bank solvency. Continued safeguards to preserve solvency constitute an integral part of the system of federal supervision over the operation of banks and trust companies. As an indication of the success of The Fed's. efforts to maintain the solvency of its member banks, only two banks out of 6,149 Federal Reserve member banks were closed due to financial difficulties during the year ending December 31, 1966.62/ Both of these banks were national banks (no state member banks were involved).

The Federal Reserve Board has a general prohibition against loans to executive officers of member banks. With stated exceptions, no member bank shall extend credit to any of its own executive officers, and no executive officer of a member bank shall borrow from or otherwise become indebted to such bank.63/ In addition, with stated exceptions no member bank shall extend credit to a partnership in which one or more executive officers of the bank are partners possessing either individually or jointly a majority interest in the partnership. No such partnership shall borrow from or otherwise become indebted to a member bank.64/ The exceptions permit a limited amount of money to be loaned to a bank's executive officers for specified purposes.65/ Whenever there is such an extension of credit, it shall be (a) promptly reported to the bank's board of directors; (b) shall be on terms not more favorable than those afforded other borrowers

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60/ Ibid.

61/ "The Federal Reserve System Purposes and Functions" (5th Ed. 1967) p. 64.

62/ See Table 103, F.D.I.C. 1966 Annual Reports, Exhibit No. A-1 supra note 1, for the total number of Federal Reserve banks for the year ending Dec. 31, 1966. See Tables 121-122, pp. 184-85 for the number and listing of the banks which closed during 1966 because of financial difficulties.

63/ 12 C.F.R. 215.3(a).

64/ 12 C.F.R. 215.3(b).

65/ 12 C.F.R. 215.4(b).

with a similar credit standing; and (c) each member bank must submit a report of such loans to The Fed.66/

In general, officers, directors, employees of member banks are prohibited from acting as or being associated with dealers in securities. This prohibition provides in pertinent part:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual primarily engaged in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail, or through syndicate participation of stocks, bonds, or other similar securities, can legally be at the same time an officer, director, or employee of any member bank of the Federal Reserve System67/

There are exceptions to this prohibition relating to dealing in certain types of securities.68/ This restriction has particular relevance to our hearings because (a) it directly relates to the maintenance of the solvency of member banks; and (b) it relates to the operation of the trust department of member banks.

The prohibition is intended to prevent a conflict of interest situation in which an officer, director, or employee of a bank may maximize his personal gain as a securities dealer at the expense of the member bank. Such a conflict of interest may produce a series of unwise investment of bank funds which would directly affect its continued solvency. If the bank officer, etc. exercises control over the trust department to the member bank, then this conflict of interest could lead to a loss of trust funds in the trusts administered by the bank. For example, a dealer could engage in "scalping"69/ which could result in the trust funds being invested in speculative securities. Any loss resulting from scalping would directly reduce these funds.

In addition to the regulations already mentioned, the Board of Governors has also promulgated detailed rules in other areas including (a) governing bank holding companies;70/ (b) interlocking bank directorates under the

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66/ 12 C.F.R. 215.5-7.

67/ 12 U.S.C. 78.

68/ 12 C.F.R. 218.2. These exemptions pertain to various types of governmental securities.

69/ "Scalping" is a term used to describe the following type of transaction. An individual purchases securities in X corporation. He then persuades others, e.g. a union or a welfare or pension plan, to invest in the same securities, which will hopefully cause an appreciation in value. He then sells his holdings in X corporation at a profit.

70/ 12 C.F.R. section 222 (Regulation G).

[illegible] 71/ and advances and discounts by the Federal Reserve banks. 72/ Those regulations are basically concerned with matters not relating to the subject of this rule making hearing. However, they indirectly accomplish a result which is connected with this hearing, preventing potential conflicts of interest which could adversely effect the solvency of member banks, and providing additional funds to member banks to enable them to meet their obligations.

The Fed. has not formulated detailed regulations governing the operations of the trust departments of member banks. The trust departments of national banks are governed by the Comptroller of the Currency pursuant to section 92(a) 73/ of the Federal Banking Laws and 12 C.F.R. section 9.1 et seq. (a detailed discussion of these rules and regulations has been already set forth in the section dealing with national banks). State member banks must adhere to state law in the operation of their fiduciary departments. In addition, as a practical matter, The Fed. requires state member banks to adhere to the standards promulgated by the Comptroller of the Currency where these standards do not conflict with state law.

As in the case of national banks, the scope of regulation of trust departments extends to their organizational structure, and all phases of their operations. These departments are in a sense treated as separate entities, required to comply with regulations not imposed upon other departments of the bank. These standards are enforced through periodic examination of these departments by The Fed., in the case of state member banks, and by Comptroller in the case of national banks.

The Fed. requires its member institutions to submit periodic reports of condition as part of its overall scheme of supervision. The basic purpose of these reports, as is the case with the reports required by the Comptroller, is to insure that the member banks adhere to the statutory and regulatory provisions governing their operation. National banks are not required to submit call reports directly to The Fed. because, as stated before, these banks are solely responsible to the Comptroller. Thus the form and contents of their periodic reports are governed by him. However, the Comptroller is required to forward copies of these reports to The Fed. for the latter's independent examination of their contents.

The state members banks are under the direct supervision of The Fed., and are required to file reports of condition at least three times each year to the Federal Reserve bank in their district. The form of the reports and the information they are to contain is determined by the

71/ 12 C.F.R. section 212 (Regulation L)

72/ 12 C.F.R. section 201 (Regulation A)

73/ 12 U.S.C. 92(a).

Board of Governors. The Fed. prescribes the detail of information which is to be included, the dates of reporting and the manner of publication of the reports.74/ These call reports are essentially the same as those required of national banks by the Comptroller.

A state bank must submit a report within ten days after the date when its district Federal Reserve bank requested the report. Failure to submit this report within the ten day period will result in the bank being fined $100 per day for each day beyond this ten day limit.75/ Any officer, director, agent, or employee of a member bank who makes a false entry in the bank's reports, books, or statements is subject to a fine, or imprisonment, or both.76/

Within twenty days after a Federal Reserve bank has called for a report by a state member bank, the reporting bank must publish this report in a newspaper of general circulation published in the place where the bank is located or in an adjoining county at least once per week.77/ The published information must be identical with that on the report of condition submitted to the Federal Reserve bank (with some minor exceptions). The copy of the report for publication is to be prepared on the form supplied or authorized for this purpose by the Federal Reserve bank.78/ After the report has been printed, a copy of the printed document is to be submitted to The Fed.

As in the case of national banks, each state member bank is required to obtain a report from any affiliate other than a member of the Federal Reserve system, which must be submitted to The Fed. at the same time as the member bank's report of condition. The purpose of these affiliate reports is to apprise The Fed. of the effect of the relationship between the member bank and the affiliate upon the affairs of the bank.79/ Each report of an affiliate must be published at the same time, and in the same newspaper as the member bank's own condition report unless an extension of time for the submission of the affiliate report has been granted.80/ The published report must contain the same information as that submitted to The Fed., and must follow a specified form.

74/ 2 CCH Fed. Bank. Rep. paragraph 35,709.

75/ Ibid.

76/ 18 U.S.C. 1005.

77/ 12 C.F.R. 208.9(a) (Regulation H).

78/ Ibid.

79/ 12 C.F.R. 208.9(b).

80/ Ibid.

As in the case of the national bank reports, The Fed. reports serve two basic supervisory functions. First, the report is intended to fully disclose to The Fed. and to member bank customers, all phases of the reporting bank's operations for the period covered. This function is similar to that performed by WPPDA section 7. In addition, these reports provide The Fed. with the necessary information to determine whether the state member banks are in fact adhering to the provisions of the Federal Reserve Act and the regulations promulgated pursuant to it. The WPPDA does not provide for a comparable supervisory function.

The most vital supervisory function performed by The Fed. is the periodic examination of state member banks. Examinations of national banks are handled by the Comptroller, who supplies a copy of the examination report to The Fed. The Fed. is authorized, at its discretion, to examine the accounts, books and affairs of each state member bank. These examinations are performed by examiners employed by each of the Federal Reserve banks, subject to the approval of The Fed. These examiners are empowered to delve into all of the affairs of the bank including (a) examining its officers and agents; (b) examining the officers of non-member affiliates as deeply as necessary to disclose the effect of these relationships on the affairs of the state member bank; (c) the cash, collateral, and all negotiable securities held in the bank; (d) all loans made and discounts given; and (e) the genuineness of all notes held by the bank. The examination may embrace every phase of banking activity found in the particular bank under scrutiny, or may concentrate in specific areas of bank activities which merit special attention. 31/ The basic concern of these examinations is to protect the net worth of the bank in question, and to insure compliance with applicable statutes and regulations.

Each Federal Reserve bank employs and trains its own examiners, subject to the approval of The Fed. The actual procedures followed by these examiners are essentially the same as those followed in the examination of national banks. The trust departments of state member banks are examined as separate entities by examiners specially trained for this purpose. The scrutiny of the trust department is geared to determine (a) whether the trust department is functioning in accordance with federal and state law; (b) whether all assets are accounted for, and all books and records are complete and up to date; (c) whether selected fiduciary accounts are being managed in accordance with the terms of the trust agreement, and applicable local law; and (d) whether the trust department is functioning in accordance with accepted fiduciary standards.

Examinations made by state authorities which meet the approval of the directors of the Federal Reserve Bank of the district in which the examined bank is situated may be accepted in lieu of those conducted by The Fed's. examiners. However, The Fed. has the option of ordering that special examinations be held by persons of their own selection. 31-a/

31/ Oral interview with Mr. Robert Schremp of the House Committee on Banking and Currency Staff in March 1968.

31-a/ 2 CCH Fed. Bank Rep. paragraph 35,707.

This policy appears to extend to the examination of trust departments as well as other bank departments.

The examiner submits a full report of his findings to the Federal Reserve bank which outlines in detail the problem areas in the particular institution. These reports are studied, and specific recommendations are made. If the specific institution fails to adopt these recommendations and rectify any unlawful or unwise practices, its membership in The Fed. is subject to revocation.

The Fed. as a matter of practice, requires bonding of all state member banks (national banks are required to be bonded by the Comptroller). In addition, all member banks are automatically insured under F.D.I.C. which requires adequate bonding for all its insured banks.82/ It is not clear whether The Fed. adopts the American Banker's Association Insurance and Protective Committee standards83/ as the minimum requirements necessary to constitute adequate bonding.

82/ 12 U.S.C. 1828.

83/ See note 48. This table of minimum standards is included in Exhibit No. A-8.

D. Supervision by the Federal Deposit Insurance Corporation

The Federal Deposit Insurance Corporation (hereinafter referred to as the F.D.I.C.) is primarily an insurance agency which protects the depositor of insured banks from losses due to bank failure. The Corporation is headed by a board of directors composed of three members, one of which is the Comptroller of the Currency. It is divided into twelve districts, each headed by a supervisory examiner who is responsible to the board for the exercise of supervision over the insured banks.84/

The F.D.I.C. insures the deposits of each depositor in an insured bank up to $15,000. The term "deposits", defined in section 3(l) of the Federal Deposit Insurance Act, includes trust funds received or held by an insured bank in its own trust department or in any other department in the bank.85/ Each trust estate is insured up to $15,000, and this insurance is separate from, and additional to the insurance covering other deposits of beneficiaries.86/

The creation of an insurance reserve is provided by the F.D.I.C.'s annual assessment against insured banks. This assessment is at the rate of 1/12 of 1 percent of the average deposits (less certain authorized deductions) of each insured bank. At the end of each year, the F.D.I.C. transfers 40 percent of this assessment income to its capital account, and credits the other 60 percent pro-rata to the next semiannual assessment of each insured bank.87/

The F.D.I.C. is not authorized to charter, or close a bank. Its functions primarily as a supervisory agency, determining (a) whether or not a bank or proposed bank meets its requirements for insurance; and (b) after a bank has been insured, whether or not the bank's conditions and operations warrant the continuance of deposit insurance. Since the F.D.I.C. is obligated to pay up to $15,000 per depositor, in the event of an insured bank's failure to meet its obligations, it is directly concerned with maintaining the solvency of its insured banks and minimizing their losses.

All banks that are members of the Federal Reserve System (national and state member banks) are automatically insured by the F.D.I.C. These banks need not make formal application to obtain insurance coverage; all

84/ "Supervisory Agencies Interest In Trust Operations" by William A. Sandlin, A doctoral thesis, 1966.

85/ Federal Deposit Insurance Act (F.D.I.A.) Section 7(i) - The term "trust funds" appears to be limited to uninvested trust funds. The F.D.I.A. is submitted as Exhibit No. A-9.

86/ Ibid.

87/ Ibid. Section 7(b)(1).

that is necessary is that the Comptroller, or The Fed. certify that these banks meet the F.D.I.C. requirements for insurance. Any state non-member bank 88/ may become insured by filing the appropriate application with the F.D.I.C. board of directors. The board must consider the following factors before membership may be approved:

(1) The financial history and condition of the bank;

(2) The adequacy of its capital structure. As part of the evaluation the F.D.I.C. requires newly organized banks to furnish a projection of estimated deposit liability at the end of three years;

(3) Its future earnings prospects;

(4) The general character of its management; and

(5) The convenience and needs of the community to be served by the bank;

(6) Whether or not its corporate powers are consistent with the purposes of the Federal Deposit Insurance Act.89/

The F.D.I.C. does not set out specific minimum capital requirements; however, it is generally agreed that in considering factor No. (1) above, they follow the general guidelines set forth by the Comptroller and The Fed. It is believed that the absolute minimum capital necessary to obtain F.D.I.C. insurance is $50,000.90/

The scope of supervision of insured non-member banks is essentially the same as that exercised by the Comptroller and The Fed. However, unlike the other federal agencies, the F.D.I.C. does not enumerate in its regulations detailed requirements which must be complied with in order to maintain an insured status. This can be partially explained by the fact that state non-member banks are chartered and primarily regulated by the 50 states. Minimum capital requirements, reserve requirements, regulation of loans, defining of corporate powers, and the regulation of the conduct of fiduciary powers are provided by each of the 50 states, and the non-member insured banks must comply with these mandates. The national banks and state member banks are regulated by their respective agencies, and are not subject to direct control by the F.D.I.C.

88/ A state non-member bank is one that is chartered by state banking authorities, and is not part of the Federal Reserve System.

89/ Federal Deposit Insurance Act, Section 6.

90/ Supra, note 84 at p. 45.

In addition, the F.D.I.C. has a more limited interest in its insured banks than do the other regulatory agencies. This interest is to maintain its insured banks in a sufficiently solvent state so that their insurance liability will be minimized. The Comptroller and The Fed. have a much broader interest in the banks subject to their regulation. The former is a chartering agency which controls all phases of the organization and operations of a national bank. The latter is concerned with the maintenance of a stable monetary system, and therefore exercises specific controls over its member banks.

The F.D.I.C., as a matter of practice, requires the same standards and procedures that are specifically enumerated in the regulations of the Comptroller and The Fed. The scope of its control over state non-member insured is as follows:

(1) To terminate the insured status of any bank which continues, after notice and hearing, to engage in unsafe and unsound banking practices.

(2) To require periodic call reports of condition which are utilized (a) to determine the bank's annual assessment for insurance coverage, and (b) to determine continuous adherence to safe and sound banking practices.

(3) To examine periodically insured non-member banks, and to make special examinations of any state bank, or national bank when deemed necessary to determine the condition of such bank for insurance purposes.

(4) To require insurance protection (in the form of adequate bonding coverage) against burglary, defalcation and other similar loss.

(5) To act as a receiver for all national banks placed in receivership, and any state banks so placed when appointed by state authorities.91/

The F.D.I.C. has promulgated some specific regulations governing the operations of non-member insured banks. These banks are expressly prohibited from exercising, taking, or assuming the following powers:

(a) to do a surety business;

(b) to insure the fidelity of others;

(c) to engage in insuring, guaranteeing or certifying titles to real estate; or

(d) to guarantee or become surety upon the obligations of others.92/

91/ 1 CCH Fed. Bank. Rep. Paragraph 1558.

92/ 12 CFR 332.1-2. If the bank in question became an insured bank before the effective date of this regulation, it is prohibited from using these enumerated powers (a) if it did not possess them at the effective date; or (b) if, although it had such powers at the effective date, it did not exercise them.

They are also expressly prohibited from permitting any change to be made in the general character or type of business exercised by such bank without the prior written consent of the F.D.I.C.

The rationale behind these prohibitions is that the exercise of the powers prohibited, or the change in the type of business carried on by the institution in question may have an adverse effect on its solvency. For example, a bank that acts as a surety for the obligations of others could incur liability which would produce a substantial loss in bank assets. Such a loss would adversely effect the F.D.I.C. because it would increase the likelihood of an insurance loss. A change in the general character of the business of a bank alters the risk undertaken by the F.D.I.C. To protect itself from taking an undue risk of loss, the F.D.I.C. prohibits such a change without its prior permission.

The F.D.I.C. limits the rates of interest, or dividends paid by insured non-member banks on time, and savings deposits.93/ 12 CFR 329.3 provides in pertinent part:

> No insured non-member bank shall pay interest on any time deposit or savings deposit in any manner, directly or indirectly, or by any method, practice, or device whatsoever. . . at a rate of interest in excess of such applicable maximum rate as the Board of Directors of the Federal Deposit Insurance Corporation shall set forth from time to time. . . .

Pursuant to this regulation, the Board of Directors has formulated various maximum rates of interests depending upon the size of the deposits, and their maturity dates.94/ These maximum rates are another method of insuring that the insured banks maintain continued solvency, and thus minimize the possibility that the F.D.I.C. may have to expend its funds to reimburse depositors.

The F.D.I.C. has authority to approve or disapprove a decrease in the capital of a non-member insured bank.95/ Capital is of particular importance to the F.D.I.C. because it serves as a buffer between deposits and the risks inherent in bank operations. As long as the bank's capital structure is maintained at an acceptable level, the bank can continue to meet its deposit obligation despite the normal amount of losses incurred in its

93/ 12 CFR 329.3.

94/ See 12 CFR 329.6-7.

95/ Supra, note 91.

operations. The crucial ratio is capital to deposits, and this ratio varies according to the quality of the bank's assets, and the volatibility of its deposits. The F.D.I.C. also is empowered to approve or disapprove (subject to state law) all proposed mergers between insured non-member banks, and uninsured banks. Such mergers have a direct effect of adequacy of capital, and thus are the subject of close scrutiny by the F.D.I.C.

The most far reaching supervisory powers possessed by the F.D.I.C., are to (a) terminate the insurance at any insured, state bank which has engaged, or is engaging in unsafe or unsound banking practices; (b) issue cease and desist orders, both temporary and permanent as to insured state banks engaging, or having engaged in such activities; or (c) secure the dismissal of any director or officer of any insured state bank who has by his personal dishonesty committed any violation of law, rule or regulation, or a final cease and desist order, or has participated in any unsound or unsafe banking practices which have caused or will probably cause substantial financial loss or other damage to the bank or its depositors.

Unsound and unsafe banking practices cover every phase of the operations which have relevance to a bank's continued liquidity and solvency. Relevant factors includes the following:

(a) the bank's internal system of controls;

(b) the loan and discount policy;

(c) the affairs of non-member affiliates;

(d) the investment policies of the bank;

(e) whether the bank is operating in accordance with applicable federal and state law;

(f) the managerial practices of its directors and officers; and

(g) the operations of its trust departments.

These factors are the same as those considered by the Comptroller (who is a member of the F.D.I.C. Board of Directors) and The Fed. in their supervision of national and state member banks.

The operations of a trust department is of particular interest to the F.D.I.C. The functioning of a trust department has a direct effect on the solvency of the entire bank because any losses resulting from its mismanagement will have to be reimbursed from the capital of the bank.

Past F.D.I.C. experience has indicated that losses incurred from the trust operations although less frequent than from other phases of operation are greater in amount than banks normally anticipate. The unforseen losses reduce the F.D.I.C.'s recovery in the event that it is obligated to reimburse insured depositors.96/

When the Board of Directors determines that an unsafe or unsound banking practice has occurred, or that federal or state law, or an F.D.I.C. regulation has not been complied with, they immediately notify (a) the Comptroller in the case of a national bank; (b) The Fed. in the case of a state member bank; or (c) the state supervisory agency in the case of other insured banks, of the practices which must be corrected. A duplicate copy of this notice is submitted to the offending bank.97/ The bank is permitted 120 days (in some cases, a shorter period is allotted)98/ to make the necessary changes voluntarily. If the offending bank does not act within this time period, the board of directors is empowered to commence proceedings to terminate the bank's insured status.

The Board issues a notice of intention to terminate the bank's status in which it fixes a time and place for a hearing (before it or a designee) to determine whether there has in fact been any wrongdoing.99/ If the Board reaches an affirmative conclusion, then the F.D.I.C. may terminate the insured status of the bank. In the event that the insured status of a bank is terminated, each depositor continues to be insured for an additional two years, and the bank in question must continue to pay to the F.D.I.C. its assessments during this period.100/

In addition to terminating an insured bank's membership in the F.D.I.C., the Board of Directors and the other federal banking agencies are also empowered to issue cease and desist orders where there is reasonable cause to believe that an insured bank is engaging, has engaged, or is about to engage in an unsafe or unsound banking practice, violate federal or state law, etc. A notice of the charge is issued by the appropriate agency, and served upon the bank in question. This notice contains a statement of the facts constituting the alleged violation, or unsafe practice, and fixes a

96/ Supra, note 183, p. 9.

97/ The Federal Deposit Insurance Act. Section 8(a).

98/ Ibid. A shorter period is given where the Board of Directors determines that the insurance risk to the F.D.I.C. is unduly jeopardized. The Comptroller, The Fed. and the state supervisory authorities are also empowered to provide for a shorter time period.

99/ Ibid.

100/ Ibid.

time and place at which a hearing will be held to determine whether the cease and desist order shall be issued. This hearing cannot be held less than 30 days, nor later than 60 days after the service of this notice unless an earlier or later date is set by the agency at the request of the bank.101/ This hearing appears to be separate and distinct from the hearing to determine whether a bank's insured status should be terminated; however, the procedure followed is basically identical.102/ If the hearing results in an affirmative finding, a cease and desist order can be issued in either a mandatory or prohibitory form.103/

If the violation, threatened violation, or unsafe or unsound banking practices are likely to cause (a) insolvency; (b) a substantial dissipation of the assets or earnings of a bank; (c) other serious prejudice to the interests of the depositors, the agency may issue a temporary cease and desist order. The order becomes effective upon service upon a bank, and unless it is set aside, limited, or suspended by a court, remains effective and enforceable pending the completion of the administrative proceedings necessary to obtain a permanent cease and desist order.104/ The offending bank may apply to the appropriate United States District Court for an injunction setting aside, limiting, or suspending this order within ten days after it has been served.105/ This temporary order is enforced by injunction.106/

A director of an insured bank is subject to removal if by his own personal dishonesty he has participated in an unsafe or unsound banking practice, violation of federal or state law or a final cease and desist order, or has engaged in any act, omission, or practice which constitutes a breach of his fiduciary duty which would cause a substantial financial loss, or other damage to the bank or its depositors. The procedure by which the offending director is removed is similar to that governing the termination of the insured status of an F.D.I.C. bank. It includes the adequate notice of the intention to remove, a full hearing before the appropriate Federal agency, and the right to judicial review of the final hearing determination.107/

101/ Federal Deposit Insurance Act. Section 8(b)(1).

102/ The requirements of adequate notice, hearing before the appropriate agencies, formal findings of fact, and judicial review govern both types of hearings.

103/ Supra, note 101.

104/ Federal Deposit Insurance Act. Section 8(c)(1).

105/ Ibid. See 8(c)(2).

106/ Ibid.

107/ Federal Deposit Insurance Act. Section 8(e)(1) et seq.

These enforcement powers, the power to terminate F.D.I.C. insurance, the power to issue cease and desist orders, and the power to remove a director for cause, constitute a vital portion of the overall supervisory scheme exercised by the F.D.I.C., and the other federal banking agencies over insured banks. They permit these agencies to obtain the immediate correction of any practices, or violations which effect the present or prospective solvency or liquidity of these banks.

The two basic methods used by the F.D.I.C. to determine whether unsafe and unsound banking practices, violations of federal or state law, etc. have occurred through (a) requiring periodic reports of condition, and (b) conducting periodic surprise examinations of insured banks. The F.D.I.C. requires reports, and conducts examinations only in the case of insured, non-member state banks. National banks submit reports to, and are examined by the Comptroller; state member banks submit reports to, and are examined by The Fed. These agencies submit the reports of condition and the bank examination results to the F.D.I.C. for their study.108/

The periodic reports of condition serve two basic functions. They are used to determine the amount that each insured bank is to be assessed each year to maintain the F.D.I.C. insurance reserve. They also provide the F.D.I.C. with information upon which it can determine whether the insured bank is operating in a proper manner.

The reports of condition required by the F.D.I.C. are similar to those mandated by the Comptroller, and The Fed. Section 7(a) of the Federal Deposit Insurance Act provides in pertinent part:

> (1) Each insured State non-member bank (except a District bank) shall make to the Corporation reports of condition which shall be in such form and shall contain such information as the Board of Directors may require. Such reports shall be made to the Corporation on the dates selected as provided in paragraph (3) of this subsection and the deposit liabilities shall be reported therein in accordance with and pursuant to paragraphs (4) and (5) of this subsection. The Board of Directors may call for additional reports of condition on dates to be fixed by it and may call for such other reports as the Board may from time to time require. The Board of Directors may require reports of condition to be published in such manner, not inconsistent with any applicable law, as it may direct. Every such bank which fails to make or publish any such report within ten days shall be subject to a penalty of not more than $100 for each day of such failure recoverable by the Corporation for its use.

108/ Ibid. Section 7(a)(2).

Section 7(a)(3) requires that insured banks submit four reports of condition yearly, two in each six month period. The National banks, and state member banks submit these reports to the Comptroller, and The Fed. respectively, with the precise call dates determined by these latter agencies. However, the call dates for all insured banks must be the same. Each of these reports contains a declaration by the president, a vice-president, the cashier, the treasurer, or other designated official,109/ that the report is true and correct to the best of his belief.110/ The correctness of said report of condition shall be attested by the signatures of at least three directors or trustees,111/ with a declaration that the report has been examined by them and to the best of their knowledge and belief is true and correct.112/ These attestation requirements are similar to those required of plan administrators by the WPPDA.

The contents of these reports are to include (a) the total amount of liability of the bank for deposits; (b) the amount of trust funds held in the bank's trust department with the reporting bank keeps segregated and apart from its general assets; (c) any change which occurs in the voting in the bank; and (d) any loan or loans which are secured by 25 percent or more of the outstanding noting stock of an insured bank (with two exceptions113/). There is no statutory requirement that these reports be published in a local newspaper, but it appears that the F.D.I.C. requires such publication.

The most important supervisory function performed by the F.D.I.C. is the periodic surprise examination of state non-member insured banks. National banks are examined by the Comptroller and state member banks by The Fed., and in each case, these agencies submit copies of their examination reports to the F.D.I.C. for their study. The Federal Deposit Insurance Act empowers the F.D.I.C. to examine (a) any state non-member bank making application to become an insured bank; and (c) any closed insured bank, whenever the Board of Directors deems that such an examination is necessary.114/ In addition to the above examinations, these examiners also have the power to make special examinations of any state member bank and any national bank or District bank, whenever this is deemed necessary to determine the

109/ The Board of Directors, or Trustees of the reporting bank are empowered to designate an appropriate officer to make the declaration.

110/ Federal Deposit Insurance Act. Section 7(a)(3).

111/ Where there are not more than three directors or trustees, at least two must attest to the correctness of these reports.

112/ Supra, note 110.

113/ Federal Deposit Insurance Act. Section 7(a)(4), j(1) and (2).

114/ Federal Deposit Insurance Act. Section 10(b).

condition of this bank for insurance purposes.115/ In conducting the examination of insured banks, examiners are empowered to scrutinize the affairs of affiliates of insured banks, in such detail as is necessary to disclose fully the relations between them.116/

The examination power is far-reaching, extending to all affairs of the insured bank, and its affiliates that are necessary to fully disclose the financial condition of the institution being examined. It includes scrutiny of the cash, collateral, and all negotiable securities held in the bank; all loans made and discounts given; internal controls employed by the bank; and scrutiny of the bank's notes for their genuineness. The F.D.I.C. utilizes the examination procedure to encourage banks to adopt an adequate program of internal controls, specifically an effective audit program.117/

In general, the F.D.I.C. examinations seek to determine the quality of assets, quality of management, adequacy of capital, and whether the bank is being operated according to applicable laws and regulations. Subsequent to the examination, the examiner files a report specifying in detail the areas in which there are unsafe or unsound practices, or violations of applicable laws or regulations to the supervisory examiner of the district in question (the supervisory examiner forwards the report to the Board of Directors with his recommendation). The bank examiner discusses the unsatisfactory practices with the bank's management informally, and attempts to obtain corrective action. If these practices are not altered as a result of this procedure, the F.D.I.C. has authority to commence proceedings for the involuntary termination of the bank's deposit insurance (as discussed in detail previously).

The trust departments of state non-member banks are examined by the F.D.I.C. as a separate entity by examiners specifically trained for this purpose. The trust departments are primarily regulated by the states; however, the F.D.I.C. has general guidelines as to how a trust department is to be operated which are basically the same as those imposed by The Fed., and the Comptroller. These examinations are geared to determine (a) whether the trust department is operating according to federal or state law; (b) whether the books and records are complete and up to date; (c) whether selected fiduciary accounts are being managed properly; and

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115/ Ibid.

116/ Ibid.

117/ Supra, note 5 at p. 51.

(c) whether the trust department is functioning in accordance with accepted fiduciary standards. The results of these trust examinations are included in the examination reports of the insured banks. Any violations or unsound practices discovered are handled in the same manner as those in any other bank department, through informal discussion, and if necessary, the commencement of formal proceedings to terminate its insured status.

The F.D.I.C. as an additional safeguard against a depletion of bank assets, requires adequate fidelity bonding of all insured banks.118/ 12 U.S.C. 1828 provides in pertinent part:

> (e) The F.D.I.C. may require any insured bank to provide protection and indemnity against burglary, defalcation and other similar insurable losses. In the event that any insured bank refuses to comply with such a requirement, the F.D.I.C. may contract for such protection and indemnity and add the cost thereof to the assessment otherwise payable by such banks.

The F.D.I.C. reviews the adequacy of fidelity coverage as a part of each bank examination. It adopts, as a general guideline for coverage, the minimum standards formulated by the American Bankers Association Insurance and Protective Committee,119/ and modifies these amounts in accordance with its own views as to the proper bonding amounts for particular banks.

The Federal banking agencies provide three distinct forms of protection against loss for welfare or pension funds entrusted to the care of a covered bank. Every federally regulated bank is required to maintain fidelity coverage which is adequate, in view of the particular factors effecting the bank, to cover ordinary losses. In addition, the F.D.I.C. insures all deposit accounts and all uninvested trust funds for up to $15,000 per depositor (or beneficiary). Finally, federal supervision is geared to maintaining the banks in a sufficiently solvent condition to be able to meet its obligations, including losses which are not covered by the fidelity bonds, or F.D.I.C. insurance.

118/ All national and state member banks are insured by the F.D.I.C. and are thus required to be adequately bonded in accordance with its regulations. The actual bonding amounts are controlled by the Comptroller and The Fed. respectively. As of December 3, 1966, 13,873 of 14,291 commercial banks were insured by F.D.I.C. and therefore required to be adequately bonded. See F.D.I.C. Annual Report for 1966, Table 103, p. 132 (See Exhibit A-1).

119/ See note 48 and Exhibit No. A-8 for enumeration of these standards.

E. Basic Minimum Bond Coverages of the American Bankers' Association

The American Bankers' Association (hereinafter referred to as the A.B.A.) Insurance and Protective Committee has formulated a table of suggested amounts of adequate bonding coverage which provides as follows:

Amounts of Blanket Bond Coverage

Group	Banks with Deposits of		Suggested Range of Amounts	
1	Less than $750,000		$25,000 to	$50,000
2	$750,000 to	$1,500,000	50,000 to	75,000
3	1,500,000 to	2,000,000	75,000 to	90,000
4	2,000,000 to	3,000,000	90,000 to	120,000
5	3,000,000 to	5,000,000	120,000 to	150,000
6	5,000,000 to	7,500,000	150,000 to	175,000
7	7,500,000 to	10,000,000	175,000 to	200,000
8	10,000,000 to	15,000,000	200,000 to	250,000
9	15,000,000 to	20,000,000	250,000 to	300,000
10	20,000,000 to	25,000,000	300,000 to	350,000
11	25,000,000 to	35,000,000	350,000 to	450,000
12	35,000,000 to	50,000,000	450,000 to	550,000
13	50,000,000 to	75,000,000	550,000 to	700,000
14	75,000,000 to	100,000,000	700,000 to	850,000
15	100,000,000 to	150,000,000	850,000 to	1,200,000
16	150,000,000 to	250,000,000	1,200,000 to	1,700,000
17	250,000,000 to	500,000,000	1,700,000 to	2,500,000
18	500,000,000 to	1,000,000,000	2,500,000 to	4,000,000
19	1,000,000,000 to	2,000,000,000	4,000,000 to	6,000,000
20	Over $2,000,000,000		6,000,000 and up	

Experience has shown that losses in excess of the above suggested amounts almost invariably are the result of infidelity. Therefore, the Insurance and Protective Committee recommends that the boards of directors of all banks seriously consider supplementing bankers blanket bonds with $1 million excess employee dishonesty insurance (see p. 46). 120/

The Committee specifically states that the table constitutes a basic guide, and that each bank should carefully analyze its own exposure to loss when determining the amount of coverage that it should carry. 121/

120/ Digest of Bank Insurance, The American Bankers' Association Insurance and Protective Committee p. 49. Exhibit No. A-8 consists of this table, and additional charts which indicate the bonding coverage in each group in 1959; a list of the different forms of bank insurance; and the principal differences in different types of blanket bond coverage.

121/ Ibid. p. 48.

The F.D.I.C. utilizes it as a general guide, and the Comptroller and The Fed. also appear to grant it great weight in the determination of what constitutes adequate bonding coverage.

Fully adequate coverage means 100 percent insurance on the largest amount that a defaulting bank officer or employee may steal or embezzle.122/ This amount is difficult to determine, particularly in the case of long-concealed dishonesty losses which can reach catastrophic amounts. There is no fixed or absolutely reliable yardstick for measuring a truly adequate amount of blanket bond coverage even among banks of similar size groups. However, there is a reasonable basis upon which a somewhat reliable table can be formulated.

It has been determined that most bank defalcations involve direct or indirect manipulation of deposit accounts.123/ Accordingly, the A.B.A. has adopted the total deposits of commercial banks as an appropriate standard upon which to base suggested amounts of bankers' blanket bond coverage. These figures therefore are only intended to represent reasonable amounts for the majority of the banks in each deposit-size group in view of the present conditions in bank operations. There is a recognition that the operation of some banks could warrant carrying lower amounts while in other cases, substantially higher amounts should be carried.

These basic amounts are effected by the following kinds of factors. Unusually large amounts of cash on hand, or volumes of owned, collateral, trust, or safekeeping securities on the premises in comparison with the total bank deposits, would merit blanket bonds in higher amounts.124/ The adequacy of internal controls and auditing procedures are of vital importance in the determination of bonding amounts. In banks where audits by independent accountants are not made periodically or where the scope of internal procedures is limited, higher amounts of bond coverage, or excess employee dishonesty insurance should be considered.125/

122/ "Is Your Financial Blanket Bond Coverage Adequate", Lester A. Pratt, Reprinted from Banking (American Bankers' Association, June, 1964) p. 2 of reprint. A copy of this reprint is submitted as Exhibit No. A-15.

123/ Ibid.

124/ Supra, note 121.

125/ Ibid.

The suggested range in amounts is intended to apply to the spread of deposits in each group. Banks possessing deposits close to the low figure in the deposit group should use the lower amount as their basic guide, while those with deposits near the upper limit should utilize the higher limit. In addition, it is suggested that newly organized banks obtain blanket bond coverage in amounts at least 50 percent higher than those suggested by the A.B.A.126/

Despite relatively effective internal controls and audit procedures, banks of all sizes are subject to incurring a single large embezzlement loss. This type of loss is exceptional and no reasonable formulation of suggested amounts of bond coverage can be expected to be adequate. To cover this type of loss, the A.B.A. and the three federal agencies urge that banks obtain excess employee dishonesty insurance.127/ At present, there does not appear to be a federal requirement that such coverage be obtained. However, as a matter of practice all but about 20 national banks, out of a total of about 4,800, maintain the excess employee liability coverages in $1 million denominations. An excess employee liability bond is one which covers internal losses, dishonest acts of officers and employees, which result in a loss exceeding the amount provided for in the ordinary blanket bond. It is usually issued in denominations of $1 million, with the exception that banks with deposits of $1 million or less can obtain such coverage in the amount of $500,000.128/

Case histories have revealed that embezzlement losses of the proportions which necessitate such coverage are usually perpetrated by banks officials or employees that have full control of their banks' operations or of specific operations in which their dishonest acts are concealed. This makes it exceedingly difficult to discover such losses and increases the importance of maintaining excess coverage. In addition to excess liability coverage in general, a bank may obtain excess securities coverage which would apply to losses of inordinately large amounts of securities kept on bank premises.

The basic theme which pervades the A.B.A. formulation of adequate fidelity bonding is that it is better to be safe and maintain a high degree of coverage, than sorry. Though the A.B.A. does not specifically articulate this position, it is inherent in A.B.A.'s advocacy of excess liability coverage, and primary bonds in amounts exceeding those recommended in the

126/ Digest of Bank Insurance, p. 50.

127/ Ibid.

128/ Digest of Bank Insurance, Supra, note 119, p. 47.

[illegible]tion, the A.B.A. recommends stringent protective measures, e.g., independent audits and forced vacations for all bank employees, which minimize the danger that a loss will occur. These measures are intended to be utilized in conjunction with adequate bonding, not in lieu of it. This two-pronged system of protection, adequate bonding plus strict protective measures, is a basic ingredient in the federal banking agencies' supervision of banks subject to their control.

II. SCOPE OF STATE SUPERVISION OF BANKING INSTITUTIONS

II. SCOPE OF STATE SUPERVISION OF BANKING INSTITUTIONS

The exemption from bonding for banks and trust companies in 29 CFR 464.4(e)(1) was granted on the basis of the degree of supervision which is exercised over such institutions by state as well as federal agencies. This section contains a discussion of the regulatory devices utilized by the states with respect to banks and trust companies falling within their jurisdictions.

A. General Characteristics

1. Structure of State Regulatory Mechanisms

All 51 states129/ have enacted legislation aimed at supervising and regulating banks.130/ A 1964 survey showed that supervision was carried out by independent banking departments in 30 states while in 21 states the banking department was part of another broader agency such as the Department of Commerce, Department of Banking and Insurance and the like.131/ In addition to commercial banks, trust companies and mutual savings banks, some of the banking departments also supervise non-bank financial institutions. The scope of supervisory authority varies widely, ranging from Ohio's banking department which has no supervision over non-bank institutions to the banking department of New Jersey, which supervises credit unions, personal loan companies, sales finance companies, savings and loan associations, small loan companies, cemetary associations, money remitters, check cashiers, home improvement companies, motor vehicle installment sellers, insurance companies, real estate commissions and business development corporations.132/

In response to a question as to whether the funds available to his department were adequate, 19 banking supervisors answered affirmatively. 24 supervisors replied that their funds were not adequate and 8 did not respond at all.133/ Even assuming that these latter would have responded

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129/ For purposes of this section, 51 states includes the Commonwealth of Puerto Rico. The District of Columbia is not included because its banks are supervised by the Comptroller of the Currency.

130/ As of 1964 there were a total of 71 private banks in the United States which are supervised by neither State nor Federal agencies. These banks are in Georgia (54), Texas (10), and Iowa (7), and are not exempted from the WPPDA bonding requirement by 29 CFR 464.4(e)(1). "State Banking," Ninth Quinquennial Survey, State Bank Division, American Bankers Association, Wash., D. C., 1964, Part I, p. 4. This survey is submitted as Exhibit No. A-10.

131/ Id., Part I, p. 2.

132/ Id., Part I, p. 4.

133/ Id., Part I, p. 7A

affirmatively, there would still be approximately 1/2 the states with banking departments claiming to have inadequate funds. It might be assumed that these underfunded banking departments cannot perform their regulatory missions properly. On the other hand, it must be remembered that the respondents were heads of departments who might answer the question in the negative no matter how adequate their budgets were. Moreover, even assuming that funding in a given department is inadequate, it does not necessarily follow that the department's supervisory functions are impaired.

Banking Boards are found in 28 states. The numbers on the boards range from 3 to 11, but over 3/4 of the states having boards limit membership to 7 members or less. Statutory powers range from advisory responsibilities to specific powers such as approving applications for charters and branches. In virtually all cases the members of the board are elected officials or are appointed by the State Governor. Membership is confined mostly to bankers or persons with banking experience, but in only 14 states is the banking supervisor a member. Qualifications for membership range from none for such states as Maryland, Mississippi, Pennsylvania and Texas to the detailed requirements in Alabama and Missouri.134/

The State Banking Supervisor is appointed by the Governor in 40 states, elected in one state and appointed by an official (such as the Director of the Department of Commerce) or a body (such as the Banking Board) in 10 states.135/ In all but 9 states the supervisor must be covered by a surety bond. Common statutory qualifications include U. S. Citizenship (26 states), and previous banking experience (27 states). 31 states have conflict of interest provisions of varying strength. Terms of office range from the pleasure of the appointing official to life tenure, but 4 years is a common term.136/

Bank examiners and assistant examiners are selected by Civil Service Commissions on the basis of examination scores in 27 states. In the other 24 states the Supervisor commonly has sole authority to select and appoint examiners. Common indicia for measuring the adequacy of examiner work forces are the number of bank offices per examiner and the assets per examiner. On the basis of these and other indicia, 31 supervisors reported that their staffs were inadequate in 1964. For instance, the median number of offices per examiner is 13, but 19 states reported 15 or more offices

134/ Id., Part I, pp. 8-15; Alabama's qualifications are as follows: The six members must be persons of good character. Four members must have had at least 5 years experience in the 10 years next preceeding their appointment to the banking board as either an officer or director of a bank, or an examiner or other officer in a Federal or State bank supervisory agency. Three of the members during the time they hold office must be connected to a bank doing business under the laws of the State of Alabama. *Id.*, Part I, p. 11.

135/ *Id.*, Part I, pp. 16-17.

136/ Id., Part I, pp. 16-26.

per examiner. In like manner, with median assets per examiner reported at $79 million, 25 states showed more than $80 million assets per examiner.137/ 36 supervisors blamed low salary schedules for their inability to attract and retain competent staffs.138/ 12 states require fidelity bonding of examiners; $10,000 is the most common amount.139/

2. Examinations and Reports

In 1963, the nation's 8,967 state commercial banks were subject to 9,451 regular and 85 special examinations by state agencies. In addition, there were 858 investigations of new banks and branches.140/ All states have a statutory requirement that state banks be examined regularly.141/ In 36 states, at least one examination per bank is required each year; in 12 states the number is 2; one state requires 2 each year and a half and in 2 states the number is left to the discretion of the supervisor. In approximately one-half the states, it is common practice to accept examinations by the F.D.I.C. or by a Federal Reserve Bank in lieu of one of the required state examinations. This is especially true among those states which by statute are required to examine twice a year.142/

In addition to regular examinations, all state banking authorities call for reports at unannounced, irregular intervals. These "calls" are required by statute in 38 states, but even among those states where they are not a statutory requirement, calls are invariably made. 31 states make 4 calls annually, 8 states make 3 and 12 states make two. 48 states have adopted the uniform call report (a joint product of the three Federal agencies and the Interagency and Uniform Reports Committee of the National Association of Supervisors of State Banks).143/ Finally, all states require banks to file at least one report of income and dividends annually.144/

137/ Id., Part I, pp. 29, 29A, and 30.

138/ Id., Part I, p. 31; 34 supervisors also reported that their examiners receive a travel allowance below that given to F.D.I.C. examiners.

139/ Id., Part I, p. 36.

140/ Id., Part I, p. 39.

141/ Id., Part I, p. 38. Exhibit No. A-11, infra, note 151, lists statutory citations to all state examination requirements.

142/ Ibid.

143/ Id., Part I, p. 40.

144/ Ibid.

3. Requirements for New Banks

All states except one have statutory minimum capital requirements which must be met before a new bank is allowed to engage in business. The amount required varies according to the population of the area the bank expects to serve; the minimum amount required ranging from $10,000.00 to $200,000.00. In addition to the minimum capital requirement, 37 states require a paid-in surplus (usually 20%) before the bank can begin operation. Chartering authority lies with the supervisor in most states and with the Banking Board in the remainder. In nearly all states the chartering authority has discretion to grant or deny charters even where the statutory minima are met. The principal standards are community need, management capabilities and capital structure. The authorities commonly require a greater capitalization than the statutory minimum. All but six states also require, by statute or policy, that a newly chartered bank secure deposit insurance before opening for business.145/ Comparing state chartering requirements with chartering requirements for national banks, 45 supervisors indicated that their states' standards were equally or more regorous than federal standards.

4. Reserve Requirements

50 states have statutory reserve requirements. Almost all of these states differentiate between demand deposits (required percentage varies from 7 to 30, 12 to 15 being commonest) and time and savings deposits (from 3 to 20 percent, but commonly between 4 and 8 percent).146/

5. Checking Unsound Practices; Removal of Officers

All state authorities have power to check unsound practices; in 38 states this power extends to the removal of officers. 31 state statutes require an internal audit annually by or for the bank's board of directors. Most supervisors will accept an audit by licensed public accountants in lieu of an examination by the directors. 31 supervisors require, by rule or regulation, that all bank employees vacation annually, usually for a minimum of two weeks.147/

6. Trust Departments

On the average, about 22 percent of all state commercial banks exercise some trust powers. Over 3/4 of these banks, however, have trust assets of $5 million or less. The remaining quarter of the banks, as might be expected, are in those states having large commercial and industrial establishments.148/

145/ Id., Part I, pp. 41-47.

146/ Id., Part I, p. 53.

147/ Id., Part I, pp. 54-55.

148/ California, Connecticut, Delaware, Florida, Illinois, Massachusetts, New Jersey, New York, Ohio and Pennsylvania are the bulk of these. Id., Part I, pp. 60-61.

In almost all cases, the states examine trust departments with the same regularity as they examine commercial departments. 10 states have examiners who devote full time to trust departments.149/ 39 states include in their examination report forms special trust department sections, but only 14 states publish data concerning trust departments in their annual reports.150/

7. Bonding; Fidelity Insurance

All but a handful of states require or authorize fidelity bonding of officers and fund handling employees by statute. However, the states have chosen a variety of ways to express the requirement. 21 states require that a bank's board of directors arrange for fidelity151/ bonding of officers and fund-handling employees. Such bond is subject to the approval of the state's banking authority.152/ In 3 additional states153/ the banking authority is required by statute to fix the amount of the bond. In 13 states,154/ the board of directors is required to procure bonds covering officers and fund-handling employees. In these jurisdictions, there is no requirement that the bond forms and amounts be approved by the state authorities. It is noted, however, that the American Banker's Association

149/ Connecticut, Maryland, North Carolina, Pennsylvania, Wisconsin, California, Illinois, Iowa, Massachusetts, and Ohio. The first five of these provide specialized training for trust examiners, as do Maine, New York and Washington. Id., Part I, pp. 60-62.

150/ California, Connecticut, Illinois, Maine, Massachusetts, Michigan, Missouri, New Hampshire, Ohio, Oregon, Pennsylvania, Rhode Island, Washington, and West Virginia. Id., Part I, p. 62.

151/ In a few cases the statute requires a faithful discharge bond, which as noted above, gives wider coverage than a fidelity bond. See Exhibit No. A-11, containing a compilation of all state bonding requirements.

152/ In most cases, the bond must be approved by the banking superintendent; in a few states, by the banking board. Several of these statutes authorize the superintendent or banking board to require a bond of a higher amount than the directors have procured, but even in those states which do not explicitly authorize such action, a failure to grant approval would have the same effect. The 21 states in this category are Alabama, Arizona, Georgia, Idaho, Indiana, Kansas, Maine, Minnesota, Mississippi, Montana, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Tennessee, Utah, Virginia and Washington. Vermont has such a requirement as regards the bank's treasurer only.

153/ Colorado, Nebraska, and New Hampshire.

154/ Arkansas, Connecticut, Iowa, Louisiana, Kentucky, Michigan, Missouri, Nevada, New Jersey, Puerto Rico, South Carolina, West Virginia and Wisconsin.

has prepared a chart155/ showing the minimum recommended bonding amounts (according to the size of the bank's assets). It is believed that bankers generally follow the Association's bonding recommendations. 8 states156/ do not require bonding by statute, but do authorize the state banking authority to require bonding.

Of the remaining 6 states, Illinois and Oregon require that any bank or trust company holding funds in trust must deposit with a state authority high grade securities in an amount specified by the statute.157/ California, Rhode Island and Massachusetts have similar requirements for trust companies only.158/ Delaware, by statute, puts a lien on the capital stock, surplus and other property of a trust company making these assets specially and primarily liable for obligations of the trust company while it is acting in a trust or fiduciary capacity.159/

B. CONCLUSION

It will thus be noted that 37 of the 51 states require bonding by statute. 8 more states provide for bonding at the discretion of the banking authority. 2 others, Illinois and Oregon, provide for a system of securities deposit which appears to give at least as much protection as a surety bond would give. Only 4 states do not make provision by statute for a bonding or securities deposit system for bankers engaged in trust business (but 3 do have such requirements for trust companies). It is possible that these 4 states provide for bonding by regulation.

There is a qualitative aspect to the "other bonding arrangements" criteria. Although specific statistics are not available on this point, it is believed that virtually all state banks comply with the minimum bond amounts suggested by the American Banker's Association.160/ It is

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155/ See Exhibit No. A-8.

156/ Alaska, Hawaii, Maryland, New York, Texas, Vermont (officers and employees other than the treasurer) and Wyoming. In New York and Florida the board of directors is given authority.

157/ In Illinois, not less than $50,000; in Oregon, an amount equal to the amount held in trust which is not insured by F.D.I.C.

158/ See Exhibit No. A-11.

159/ See Exhibit No. A-11.

160/ See Exhibit No. A-8.

[illegible] that banks subject to only state regulation be placed in proper perspective. According to 1962 figures, there were only about 175 state banks with operating trust departments which were not insured by the F.D.I.C.161/ Thus, all the figures above relating to bonding requirements in the various states are applicable only to these 175 banks, since we are concerned only with banks which have trust departments and which are not regulated by any of the federal agencies. It must also be remembered that of over 14,000 banks in the United States in 1966, only one which was not insured by F.D.I.C. failed and was unable to meet its obligations.162/ One final fact is that in more than 10 years experience under the WPPDA, there have been no known losses to plan participants or beneficiaries due to bank failure, or defalcation or frauds by banks and trust department personnel.

161/ Comparative Regulations of Financial Institutions, Subcommittee Print, Committee on Domestic Finance, House Committee on Banking and Currency, 88th Cong. U. S. Government Printing Office, 1963, Table 3, p. 260.

162/ See Exhibit No. A-1, F.D.I.C. Annual Report, Table 121, p. 184.

III. FEDERAL SUPERVISION OF INVESTMENT ADVISERS - THE INVESTMENT ADVISERS ACT OF 1940

[illegible] SUPERVISION OF INVESTMENT ADVISERS - THE [illegible] ACT OF 19[illegible]

A. General View of the Act.

The Investment Adviser's Act163/ was passed in 1940 after a report by the Securities and Exchange Commission and other research caused Congress to find "that investment advisers are of national concern, in that, among other things --

(1) their advice, counsel, publications, writings analyses, and reports are furnished and distributed, and their contracts, subscription agreements, and other arrangements with clients are negotiated and performed, by the use of the mails and means and instrumentalities of interstate commerce;

(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to the purchase and sale of securities traded on national securities exchanges and in interstate over-the-counter markets, securities issued by companies engaged in business in interstate commerce, and securities issued by national banks and member banks of the Federal Reserve System; and

(3) the foregoing transactions occur in such volume as substantially to affect interstate commerce, national securities exchanges, and other securities markets, the national banking system and the national economy.164/

The I.A.A. was the last of a series of important measures designed to regulate the securities field. It was signed into law simultaneously with the Investment Company Act of 1940;165/ both acts were a logical extension of federal regulatory power which had been established by the Securities Act of 1933/166/ and the Securities Exchange Act of 1934.167/ The I.A.A. is administered by the Securities and Exchange Commission.168/

The I.A.A. defines an investment adviser as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value

163/ Act of August 22, 1940, Ch. 686, Title II, section 201, 54 Stat. 847, 15 U.S.C. 80b-1 et seq., hereinafter referred to as the I.A.A. Submitted as Exhibit No. A-13.

164/ Id., Section 80b-1.

165/ Act of August 22, 1940, Ch. 686, Title I, section 53, 54 Stat. 847.

166/ 15 U.S.C. 77a et seq.

167/ 15 U.S.C. 77b et seq.

168/ 15 U.S.C. 80b-2(a)(4), Hereinafter referred to as the S.E.C. or the Commission.

> of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities...169/

The same definition expressly excludes banks, lawyers, brokers and dealers, regular publishers, persons giving advice only about U.S. Government obligations, and such other persons as the S.E.C. may designate.170/

Three common means of regulation are employed under the I.A.A.; registration, record keeping, and auditing. In addition, there are prohibitions against certain contracts, transactions, dealings and statements. There are also provisions relating to public disclosure, enforcement, hearings and court review. The S.E.C. is given rule-making powers.

B. Registration

Section 80b-3 prohibits an investment adviser from using the mails or other instrumentalities of interstate commerce in connection with its business unless it is registered with the S.E.C. The registration form calls for the following information:

(1) the name under which business will be conducted, the name of the state in which the business is organized, location of the principal office, names and addresses of the proprietor, partners, officers or directors, and the number of employees;

(2) education, business affiliations for past 10 years and present business affiliations of all principals and persons exercising control over the firm;

(3) the nature of the business, including the manner of giving advice and rendering analyses and reports;

(4) the nature and scope of the authority of the investment adviser with respect to clients' funds and accounts;

(5) the basis on which the firm is compensated;

169/ 15 U.S.C. 80b-2(a)(11).

170/ Ibid.

(6) whether any person connected with the firm is subject to a disqualification which would be a basis for denial, suspension or revocation of the firm's registration under section 80b-3(d) (see below); and

(7) whether the firm's principal business consists of acting as an investment adviser and whether a substantial part of its business consists of rendering investment supervision services.171/

The S.E.C., under section 80b-3(d) and after opportunity for a hearing, may deny, suspend or revoke a firm's registration if it finds that a principal of the firm has made a false report or misleading statement in its registration or in any proceeding before the S.E.C., has been convicted within 10 years preceeding the registration or at any time thereafter of certain enumerated crimes, has been enjoined by a court from carrying on any one of certain business related to the securities field or has violated or aided another in violation of the Securities Act of 1933 or the Securities and Exchange Act of 1934.172/ Section 80b-3(g) provides the procedure by which a person may withdraw from registration.

Investment advisers who had fewer than 15 clients during the preceding year and who do not hold themselves out to the public as investment advisers, or whose only clients are investment companies or insurance companies or who do not give advice with respect to securities traded on national exchanges and whose clients are all in the state within which it maintains its principal office are exempted from registration by section 80b-3(b).173/

C. Reports

All investment advisers who are not exempted from registration under section 80b-3(b) must keep such records and make such reports as the S.E.C. requires. All such records are subject to reasonable periodic or special examinations, as the S.E.C. deems necessary.174/ A willfully untrue statement or a willful ommission of a material fact in any report to or proceeding of the S.E.C. under section 80b-3 is made unlawful by section 80b-7.175/

171/ 15 U.S.C. 80b-3(a) and (c).

172/ 15 U.S.C. 80b-3(d).

173/ 15 U.S.C. 80b-3(b).

174/ 15 U.S.C. 80b-4.

175/ 15 U.S.C. 80b-7.

D. Prohibited Contracts

Section 80b-5 prohibits investment advisors from using the mails or other instrumentalities of interstate commerce to enter into an investment advisory contract 176/ which:

(1) provides for compensation to the adviser on the basis of capital gains on the funds of the client;

(2) fails to provide that the investment adviser may not assign the contract without the consent of the other party thereto; or

(3) fails to provide that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of the partnership.177/

E. Prohibited Transactions

Under section 80b-6, it is unlawful for an investment adviser to use the mails or other instrumentalities of interstate commerce:

(1) to defraud a client or prospective client;

(2) to engage in any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client;

(3) acting as a principal for his own account, knowingly to sell any security to or purchase any security from a client, or to act as a broker for a person other than a client without disclosure to the client in writing before the completion of the transaction the capacity in which he is acting and obtaining the client's consent (this prohibition does not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment advisor in relation to such transaction).

(4) to engage in any act, practice or course of business which is fraudulent, deceptive or manipulative.178/

176/ An "investment advisory contract" is defined in section 80b-5 as any contract or agreement whereby a person agrees to act as investment adviser or to manage any investment or trading account for a person other than an investment company.

177/ 15 U.S.C. 80b-5. The section explicitly provides that it shall not be construed to prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date.

178/ 15 U.S.C. 80b-6. The S.E.C. is authorized to define and prescribe means reasonably designed to prevent such acts, practices and courses of business as are fraudulent, deceptive or manipulative.

F. Other Aspects of the Investment Advisers Act

The S.E.C. is given broad investigative powers under section 80b-9, including nation-wide power to subpoena witnesses and records. The Commission may invoke the aid of the Federal courts in cases of contumacy and the courts are explicitly authorized to cite for contempt. The Commission may also sue in the federal courts to enjoin violations of the I.A.A., and may transmit evidence to the Attorney General who may in his discretion institute criminal actions. Section 80b-9(d) abrogates the right to refuse to testify in any proceeding instituted by the S.E.C. on the grounds of self-incrimination and provides that no one shall be prosecuted on account of any such testimony if he has claimed the Fifth Amendment privilege.179/

Section 80b-10 authorizes the S.E.C. to make available to the public information from any registration application or report which has been filed with it pursuant to the I.A.A. Except in the case of a public hearing, which it is authorized to hold under section 80b-12, or requests from either house of Congress, the Commission may not publicize an investigation or facts ascertained in an investigation.180/

The S.E.C. is given broad power to make rules and regulations to carry out its functions under the I.A.A.181/ Section 80b-13 provides for court review for any person aggrieved by a Commission order and makes Commission findings as to facts conclusive if supported by substantial evidence. Section 80b-16 requires annual reports by the S.E.C., section 80b-17 provides for criminal penalties182/ for willful violations of the I.A.A. and section 80b-18(a) preserves the jurisdiction of state officials and agencies to perform securities regulation functions insofar as they do not conflict with the I.A.A.183/

G. S.E.C. Regulations Under the Investment Advisers Act

Pursuant to I.A.A. Section 806-11, the S.E.C. has promulgated a series of rules and regulations. These are found in 17 CFR Parts 275, 276, and

179/ 15 U.S.C. 80b-9.

180/ 15 U.S.C. 80b-10, 80b-12.

181/ 15 U.S.C. 80b-11.

182/ Fine up to $10,000.00 or up to two years' imprisonment or both.

183/ 15 U.S.C. 80b-13, 80b-16, 80b-17, 80b-18(a).

1/9. Sections which are relevant to this proceeding are summarized below. The complete regulations are included in Exhibit No. A-1[illegible].

1. Books and Records to be Maintained by Investment Advisers

Investment advisers subject to section 80b-4 and not exempted under section 203-3(b) must keep the following records:

(a) A journal of original entries, including cash receipts and disbursements records, forming the basis of entries in any ledger;

(b) Auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts;

(c) Memoranda of each order given by the investment adviser for the purchase or sale of any security and of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security. The memoranda must show the terms and conditions of the order or instruction, identify the person who recommended the transaction to the client and the person who placed the order, and must show the account for which entered, the date of entry and the bank, broker or dealer by or through whom executed.

(d) check books, bank statements, cancelled checks and cash reconciliations;

(e) bills or statements relating to the business;

(f) trial balances, financial statements and internal audit working papers related to the business;

(g) originals of written communications received and copies of all written communications sent relating to (a) any recommendation made or proposed to be made and any advice given or proposed to be given, (b) any receipt, disbursement or delivery of funds or securities, or (c) the placing or execution of any order to purchase or sell any security.

(h) a record of all accounts in which the adviser is vested with discretionary power regarding funds, securities or transactions of a client;

(i) any powers of attorney granting discretionary power to the adviser;

(j) written agreements entered into with a client relating to the business;

(k) a copy of each notice, circular or other communication recommending the purchase or sale of a specific security which is distributed, directly or indirectly by the adviser. The copy of the notice or an attached memorandum must state the reason for the recommendation;

(l) a record of every transaction in a security in which the investment adviser or an employee who participates in the recommendation process has, or by reason of such transaction acquires, any direct or indirect beneficial ownership (except (i) transactions in an account in which the adviser has no direct or indirect influence or control and (ii) transactions in securities which are direct obligations of the United States) the date and the nature of the transaction, the price at which it was effected and the name of the broker, dealer or bank through which it was effected.

(m) Where an investment adviser has custody or possession of securities or funds of any client, the records required in paragraph (l) above must also include: (i) records showing all purchases, sales, receipts and deliveries of securities (including certificate numbers for such accounts and all debits and credits to such accounts), (ii) a separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits, (iii) copies of confirmations of all transactions effected by or for the account of any such client, and (iv) a record of each security in which any such client has a position, showing the name of each client having any interest in such security, the amount or interest of each such client, and the location of each such security;

(n) Where an investment adviser renders supervisory or management services to a client he must, with respect to each client's portfolio, keep records showing the securities purchased and sold, the date, amount and price of each purchase and sale and for each security in which any such client has a current position, the name and the amount or interest of each such client.184/

2. Advertisements by Investment Advisers

The following kinds of advertisements have been defined by the S.E.C. as fraudulent, deceptive or manipulative within the meaning of 15 U.S.C. 80b-6(4):

(a) a reference to any testimonial of any kind concerning the investment adviser or any advice, analysis, report or other service rendered;

(b) a reference to past specific recommendations made by the investment adviser which were or would have been profitable to any person.

184/ 17 CFR 275.204-2(a) - (c).

[illegible] prepared is a list of all recommendations made within an immediately preceding period of not less than one year if the list contains specified information, including the legend "it should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list;"

(c) a representation that any device being offered can in and of itself be used to determine which securities to buy and sell or when to buy and sell them or that such device can assist any person in making these decisions without prominently disclosing the limitations of the device and the difficulties with respect to its use;

(d) a statement that any service will be furnished free or without charge unless the service actually will be furnished free and without condition or obligation; or

(e) any untrue statement of a material fact, or an otherwise false or misleading statement.185/

3. Custody or Possession of Funds or Securities of Clients

If an investment adviser has custody or possession of any funds or securities in which a client has a beneficial interest, it is a violation for the adviser to take any action with respect to the funds or securities, unless:

(a) the securities of each client are segregated, identified and held in safe-keeping;

(b) the funds of each client are deposited in a separate bank account, maintained in the name of the investment adviser as trustee, and separate records are kept on each account;

(c) the investment adviser notifies each client of the place and manner in which the client's securities and funds will be maintained and sends to each client at least every three months an itemized statement showing all transactions in the client's account during the period; and

(d) all such securities and funds are verified by annual examination by an independent public accountant at a time chosen by the accountant without prior notice to the adviser. The accountant must certify

185/ 17 CFR 275.206(4)-1(a) and (b).

(l) a record of every transaction in a security in which the investment adviser or an employee who participates in the recommendation process has, or by reason of such transaction acquires, any direct or indirect beneficial ownership (except (i) transactions in an account in which the adviser has no direct or indirect influence or control and (ii) transactions in securities which are direct obligations of the United States) the date and the nature of the transaction, the price at which it was effected and the name of the broker, dealer or bank through which it was effected.

(m) Where an investment adviser has custody or possession of securities or funds of any client, the records required in paragraph (1) above must also include: (i) records showing all purchases, sales, receipts and deliveries of securities (including certificate numbers for such accounts and all debits and credits to such accounts), (ii) a separate ledger account for each such client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits, (iii) copies of confirmations of all transactions effected by or for the account of any such client, and (iv) a record of each security in which any such client has a position, showing the name of each client having any interest in such security, the amount or interest of each such client, and the location of each such security;

(n) Where an investment advisor renders supervisory or management services to a client he must, with respect to each client's portfolio, keep records showing the securities purchased and sold, the date, amount and price of each purchase and sale and for each security in which any such client has a current position, the name and the amount or interest of each such client.184/

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184/ 17 CFR 275.204-2(a) - (c).

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(c) a representation that any device being offered can in and of itself be used to determine which securities to buy and sell or when to buy and sell them or that such device can assist any person in making these decisions without prominently disclosing the limitations of the device and the difficulties with respect to its use;

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(c) the investment adviser notifies each client of the place and manner in which the client's securities and funds will be maintained and sends to each client at least every three months an itemized statement showing all transactions in the client's account during the period; and

(d) all such securities and funds are verified by annual examination by an independent public accountant at a time chosen by the accountant without prior notice to the adviser. The accountant must certify

185/ 17 CFR 275.206(4)-1(a) and (b).

[illegible] to the S.E.C. 186/ The Commission also inspects investment advisers on a cyclical basis and upon receipt of a complaint. Available figures indicate, however, that those inspections are too infrequent to be considered analogous to bank examinations.187/

186/ 17 CFR 275.206(4)-2(a).

187/ As of the year ending March 31, 1967, there were 552 investment advisers from the New York area registered with the S.E.C. During that year the Commission inspected 122. For the same period, only 26 of the 334 San Francisco investment advisers were inspected. Conversation with Leonard Rossen, Branch Chief, and Ezra Weiss, Associate Chief Counsel, Securities and Exchange Commission, April 24, 1968.

IV. COMPARISON OF REGULATION OF INVESTMENT ADVISERS WITH REGULATION OF BANKS AND TRUST COMPANIES

IV. [illegible] OF REGULATION OF INVESTMENT ADVISERS WITH [illegible] AND TRUST COMPANIES

In comparing the regulation by government agencies over banks and trust companies with analogous regulation of investment advisers, there are five aspects which appear to be relevant to the issues being considered in this proceeding. These are (a) the requirements which must be met in order to conduct the business, (b) reports of condition, (c) examinations, (d) bonding, and (e) other aspects of control.

A. Requirements Which Must Be Met to Conduct Business

Before an investment adviser can conduct his business, he must register with the S.E.C. by properly completing a registration application. The information required by the application 188/ is designed to disclose basic facts about the principals in the firm and the firm's methods of business. Section 80b-3(d) of the I.A.A. sets forth four specific causes for denying, suspending or revoking registration.189/ Aside from these specific causes, the Commission is not empowered to deny an investment adviser's application.

In order for a bank to engage in business, it must meet the minimum capital requirements described above, pp. 8, 9, 19, and 46 . Minimum capital is required by all three federal regulatory agencies and by every state except one. Also, the Fed. and the Comptroller and all but one state have reserve requirements and 37 states require a paid-in surplus as well. In addition, all three federal agencies and virtually all state banking authorities have discretion to grant or deny charters on the basis of such criteria as the general character of management and personnel, the convenience and needs of the community to be served by the bank, the overall adequacy of the bank's capital structure and the bank's future earnings prospects.

B. Reports

The S.E.C. is given the power, in section 80b-4 of the I.A.A. to require reports. It presently does not require any reports on a regular basis. There are elaborate record keeping provisions in the regulations,190/ but it appears that the information thus made available is used, if at all, only where the annual audits are made or when the S.E.C. investigates after receiving a complaint.

188/ See Exhibit No. A-13 for the information called for in the registration application.

189/ Supra, p. 53 .

190/ Supra, pp. 56, 57.

The three federal banking agencies call for reports of condition four times per year from all the banks under their jurisdiction.191/ This includes all national banks and all federally regulated banks or approximately 99 percent of all banks in the United States. These call reports are circulated to the other two federal agencies for their inspection. All states also make calls, most of them four times per year. Moreover, all states require banks to file at least one report of income and dividends annually.192/

C. Examinations

The S.E.C. requires examinations of investment advisers only where the adviser has custody of a client's funds or securities. In such a case, the investment adviser is required by regulation 193/ to hire an independent accountant who makes a surprise examination on an annual basis to verify such funds and securities. The results are certified to the S.E.C. The Commission also conducts inspections of investment advisers on a cyclical basis and upon receipt of a complaint. These inspections, however, are not frequent enough to be equated with bank examinations.194/

Federal banks are examined a minimum of three times every two years, at surprise intervals. The F.D.I.C. and The Fed. examine their banks at least once a year without advance notice. Specifically trained persons examine trust departments and the Comptroller maintains close controls on trust departments.195/ All but two states have statutory examination requirements specifying at least one examination per year (the excepted two states require "regular" examinations).196/ In addition, all federal and most state banks are required to conduct internal audit programs.197/

D. Bonding

There is no bonding required of investment advisers under the I.A.A. It is doubtful, given the statutory language, that the S.E.C. could require

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191/ Supra, pp. 12, 23, 25.

192/ Supra, p.45.

193/ Supra, p. 58 and 59.

194/ Supra, note ~~187~~.

195/ Supra, pp.15, 16, 25, 36, 37.

196/ Supra, p. 45.

197/ Supra, pp. 16, 17, 36, 46.

bonding, and it has never attempted to do so. All banks insured by F.D.I.C. must carry bonding protection.198/ In setting bonding requirements, the F.D.I.C. uses the American Bankers' Association minimum bonding recommendations as a basic guide. In addition, 45 of the 51 banking jurisdictions require bonding by statute or regulation.199/

E. Other Aspects of Control

Under the I.A.A., certain contracts, transactions and advertising methods are prohibited. There is provision for public disclosure and there are criminal penalties for willful violations.200/ None of these provisions is designed to insure the financial responsibility of an investment adviser; rather they appear to be aimed at the prevention of securities frauds. All state banking authorities have power to check unsound practices and in 38 states, this authority includes power to remove bank officers.201/

198/ Supra, pp. 37 . As is pointed out in Section I , all national banks are required to bond. In addition, the F.D.I.C. requires bonding for all state insured banks.

199/ Supra, pp. 47, 48 . It is also to be remembered that an additional two states require escrow arrangements which appear to provide protection equal to that offered by bonding arrangements.

200/ Supra, p. 55.

201/ Supra, p. 46.

#5

THE ADMINISTRATOR OF NATIONAL BANKS

WASHINGTON

July 31, 1968

DRAR - BRANCH - (WP) & BONDING
Rec. AUG 2
Assigned
Ack.

Mr. Frank M. Kleiler, Director
Office of Labor-Management and
Welfare Pension Reports
United States Department of Labor
Room 801, 8701 Georgia Avenue
Silver Spring, Maryland 20910

Re: Retention by banks regulated by the Comptroller of the Currency of exemption from bonding requirements of Section 13(a) of the Welfare and Pension Plans Disclosure Act, 29 U.S.C. §308d(a) now exempt pursuant to 29 CFR §464.4(c)(1).

Dear Mr. Kleiler:

This is in response to an invitation in a June 14, 1968 Notice of Proposed Rule Making for written communications of data, views, or argument concerning the federally regulated bank and trust company exemption from the bonding requirements of the Welfare and Pension Plans Disclosure Act, (WPPDA), 29 U.S.C. §301, et seq.

Section 308(d)(e) of Title 29 expressly provides that the Secretary of Labor "may exempt" certain plans from the bonding requirements of the Act "(w)hen, in the opinion of the Secretary, the administrator of a plan offers adequate evidence of the financial responsibility of the plan, or that other bonding arrangements would provide adequate protection of the beneficiaries and participants. . . ." Since 1962, banks and trust companies have been exempt from the bonding requirements of the Act pursuant to regulations published at 29 CFR §464.4(c)(1). However, in recent litigation over the Secretary's denial of an exemption to a New York investment adviser, questions were raised by the Court of Appeals for the District of Columbia relating to the premises on which the present exemption for banks, particularly state banks, are based. Fiduciary Counsel, Inc. v. Wirtz, 383 F.2d 203, (D.C. Cir.), cert. denied, 389 U.S. 1005 (1967). Accordingly, the office of Labor-Management and Welfare Pension Reports has requested comments on the following issues:

Mr. Frank M. Kleiler

1. Whether banks and trust companies subject to <u>Federal regulation</u> should as a class retain their present exemption from the WPPDA bonding requirements in light of the criteria in section 13(e), WPPDA, 29 U.S.C. §308d(e)?

2. Whether banks and trust companies subject to <u>state regulation</u> should as a class retain their present exemption from the WPPDA bonding requirements in light of the criteria in section 13(e), WPPDA, 29 U.S.C. §308d(e)?

3. Whether investment advisers registered with and regulated by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940, 15 U.S.C. §80b and subject to 29 CFR, Part 464 should as a class be granted an exemption from the WPPDA bonding requirements in light of the criteria in section 13(e) WPPDA, 29 U.S.C. §308d(e)?

This letter is addressed to the first of those issues insofar as the term "federally regulated" applies to national banks.

Almost all commercial banks in the United States, both state and national, are insured for the benefit of their depositors by the Federal Deposit Insurance Corporation and are therefore subject to some degree of federal regulation by that agency. In addition, some state banks and all national banks are members of the Federal Reserve System which entails additional federal regulation. All national banks -- approximately 4300 banks -- are chartered and intensively regulated by the Comptroller of the Currency. The Office of the Comptroller of the Currency suggests that there well may be a valid basis for the retention by national banks of their exemption from the bonding requirements of the Welfare and Pension Plans Disclosure Act, 29 U.S.C. §301, <u>et seq</u>. because the regular examination by this Office assures a rigorous standard of financial responsibility and adequate bonding arrangements.

The authority of the Comptroller to regulate national banks is found in the National Bank Act of 1864, as amended, 12 U.S.C. §1 <u>et seq</u>. Of the approximately 4800 national banks, nearly 1700 have trust departments. No national bank can act as a trustee or in any other fiduciary capacity without obtaining a permit from the Comptroller. 12 U.S.C. §92a. Application for such a permit is carefully investigated by the Comptroller's Office. See 12 CFR 89.3. The management of, or giving of investment advice to, a welfare or pension fund is considered by the Comptroller's Office to be a fiduciary activity which could not be handled by a national bank except through a trust department authorized by this Office.

The Comptroller's Office maintains a staff of approximately 1400 examiners, 88 of whom are specialized trust department examiners. National banks are examined by this Office at least three times every two years. 12 U.S.C. §481. In addition the trust departments of national banks are subject to separate surprise examinations once each year. The Comptroller's Office has a separate trust division, under a Deputy Comptroller for Trusts and a Chief Representative in Trusts, who supervise these examinations. This Office also has published regulations governing the operation of a trust department by a national bank. See 12 CFR, Part 9. Included in these regulations are the requirement of an adequate bond (12 CFR §9.7(b)); the requirement that the national bank retain counsel (12 CFR §9.13(b) and 9.7(c)); the requirement of adequate record-keeping (12 CFR §9.8); the requirement of an internal audit (12 CFR §9.9); and the requirement that the bank's investment of fiduciary funds comply with the instrument establishing the fiduciary relationship and with the law and sound fiduciary principles (12 CFR §9.11).

In addition to the bond requirement as found at 12 CFR §9.7(b), the Comptroller has issued a ruling requiring the following:

> All officers and employees of a national bank must have adequate fidelity coverage, and the failure of directors to require bonds with adequate sureties and in sufficient amount may make them liable for any losses which the bank sustains because of the absence of such bonds. Directors should not serve as sureties on such bonds.
>
> The board of directors should determine the amount of such coverage, premised upon a consideration of such factors as (1) internal auditing safeguards employed, (2) number of employees, (3) amount of deposit liabilities, and (4) amount of cash and securities normally held by the bank, among others. Para. 5215, Comptroller's Manual for National Banks.

The American Bankers Association publishes a guideline for banks regarding the amounts of blanket bond coverage as related to deposit figures, a copy of which is attached. (Attachment A). Utilizing these guideline amounts together with a consideration of the factors enumerated in the Comptroller's ruling quoted above, an evaluation of the bank's bonding arrangements is made at the time of each regular examination. The national bank examiner is required to investigate and report the extent of the bank's fidelity and other indemnity protection. An entire page of the examination report is devoted to an analysis of the bank's bonding arrangements. A copy of the form used by this Office is attached. (Attachment B).

The Insurance and Protective Committee of the American Bankers Association has recommended that the boards of directors of all banks seriously consider supplementing bankers blanket bonds with $1 million excess employee dishonesty insurance. Based upon information available to this Office, all 4800 national banks with the possible exception of ten to twenty smaller banks carry the $1 million excess employee dishonesty insurance.

In addition to the bonding requirements recited above, the National Bank Act, 12 U.S.C. §92a(b) provides the following with respect to national banks exercising trust powers:

> Wherever the laws of a State require corporations acting in a fiduciary capacity to deposit securities with the state authorities for the protection of private or court trusts, national banks so acting shall be required to make similar deposits and securities so deposited shall be held for the protection of private or court trusts, as provided by the State law. National banks in such cases shall not be required to execute the bond usually required of individuals if state corporations under similar circumstances are exempt from this requirement. National banks shall have power to execute such bond when so required by the laws of the State.

Section 13(a), WPPDA, 29 U.S.C. §308d(a) describes the extent of the bond coverage required under the Act:

> Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of such administrator, officer, or employee, directly or through connivance with others.

In light of the multiple bonding requirements already imposed upon national banks as discussed above, and because of the complete and thorough supervision provided by this Office of all fiduciary activities of national banks, the Office of the Comptroller of the Currency suggests that the welfare and pension benefit plans under administration by the trust departments of national banks are adequately protected against loss by reason of acts of fraud or dishonesty on the part of such administrators and their employees, which may be cause for the continuation of the present exemption from the Act's bonding requirements of national banks.

Mr. Frank M. Kleiler [-5-]

I respectfully request that this letter be made a part of the record in the proceedings in this matter before the Hearing Examiners at the United States Department of Labor scheduled for August 12, 1968.

Sincerely,

William B. Camp
Comptroller of the Currency

Attachments A and B.

HLR/LMah:msd
cc: Chairman Randall
Director Sprague
Mr. Flannery
Miss Mah
Mr. Miller
Mr. DeHority - Cen. Files
Legal Files

Ex 6

August 7, 1968

Mr. Frank M. Kleiler, Director
Office of Labor-Management and
Welfare-Pension Reports
United States Department of Labor
Room 801
8701 Georgia Avenue
Silver Spring, Maryland 20910

Dear Mr. Kleiler:

This letter is in response to the Department of Labor's announcement of a hearing on August 12, 1968, to consider the question whether investment advisers regulated by the Securities and Exchange Commission and banks and trust companies subject to State or Federal regulation should be exempt from the bonding requirements imposed by the Welfare and Pension Plans Disclosure Act of 1958, as amended (29 U.S.C. 301-309) (hereinafter referred to as "the Act").

Subsection (a) of section 13 of the Act (29 U.S.C. 308d) requires every administrator, officer, and employee of any employee welfare or pension benefit plan who handles funds or other property of such plan to be bonded in an amount generally not less than 10 percent of the amount of funds handled. Subsection (e) of that section authorizes the Secretary of Labor to exempt a plan from the bonding requirements imposed by the section whenever, in his opinion, the administrator of a plan offers adequate evidence of the financial responsibility of the plan or other bonding arrangements would provide adequate protection to the beneficiaries and participants.

Pursuant to regulations of the Secretary of Labor published at 29 C.F.R. §§ 464.4(e), 465.19, and 465.20 (1968), banks or trust companies subject to regulation and examination by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation currently are exempt from the bonding requirements imposed by subsection (a) of section 13 of the Act,

whether with respect to covered plans administered for the benefit of other than their own employees or with respect to covered plans administered for the benefit of their own employees. Banks or trust companies subject only to State law and supervision by State agencies currently are exempt from the bonding requirements with respect to covered plans administered for the benefit of other than their own employees but not with respect to covered plans administered for the benefit of their own employees.

In connection with litigation involving the Secretary of Labor's denial of a petition submitted by a New York investment adviser for an exemption from the bonding requirements imposed by the Act, your office has requested comments on the issue, among others, whether banks and trust companies subject to Federal or State regulation should as a class retain their present exemption from the bonding requirements imposed by the Act in light of the criteria prescribed by subsection (e) of section 13 thereof.

It has been generally accepted that the activities of banks uniquely affect the public interest and, therefore, are properly subject to governmental supervision. Under the existing Federal-State system of banking, national banks are chartered and supervised by the Comptroller of the Currency. State banks, appropriately, are chartered and supervised by the various State supervisory authorities and become subject to examination and supervision by either the Board of Governors of the Federal Reserve System as a member bank or the Federal Deposit Insurance Corporation as an insured nonmember bank.

Banks chartered as national banks and State banks becoming members of the Federal Reserve System acquire insured status without application to the Federal Deposit Insurance Corporation upon certification to the Corporation by either the Comptroller of the Currency or the Board of Governors of the Federal Reserve System that certain factors have been considered and favorably resolved. Banks chartered by the States and not members of the Federal Reserve System, as well as noninsured operating banks, become insured upon application to and approval by the Federal Deposit Insurance Corporation. The following factors, specified by section 6 of the Federal Deposit Insurance Act (12 U.S.C. 1816), must be considered by the appropriate Federal banking agency with respect to banks seeking to be admitted to deposit insurance: (1) the financial history and condition of the bank, (2) the adequacy of its capital structure, (3) its future earnings prospects, (4) the general character of its management, (5) the convenience and needs of the community to be served by the banks, and (6) the consistency of its corporate powers with the purposes of the Federal Deposit Insurance Act.

As of December 30, 1967, 13,741 commercial banks and trust companies were operating in the United States. Of these 13,517 were subject to supervision and examination by one of the three Federal banking agencies -- i.e., the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (or the Federal Reserve banks), or the Federal Deposit Insurance Corporation -- and their deposits were insured in accordance with the provisions of the Federal Deposit Insurance Act.

This Corporation regularly examines all insured State banks that are not members of the Federal Reserve System. It is the Corporation's policy to examine such banks at least annually -- and more often if necessary -- in order to be regularly informed of each bank's financial condition and to be alerted to any conditions which may require correction. During 1967, the Corporation conducted 7,148 examinations (including 129 re-examinations) of insured State banks not members of the Federal Reserve System. During the same year, 1,092 of approximately 1,357 trust departments operated by insured State banks not members of the Federal Reserve System were examined. All other insured banks are regularly examined by either the Comptroller of the Currency or by the Federal Reserve banks.

Examinations are one of the principal tools of bank supervision. They are the instrument by which the Corporation seeks to achieve and maintain the conditions of sound banking essential to the viability of deposit insurance. Examinations provide the Corporation with information concerning its insurance risk and alert it to conditions which may require corrective measures. Though certain quantitative measures are employed in examinations, the examination is basically a qualitative appraisal of the soundness of the bank's operations. An examination involves ascertaining the character and amount of a bank's assets and liabilities, a detailed appraisal of assets, a review of the bank's policies and procedures, an evaluation of management, and a determination of whether all pertinent statutes and regulations are being observed. Trust department operations of insured State nonmember banks are closely scrutinized by examiners specially trained for this type of work. Special emphasis is placed upon the competency and the effectiveness of trust department management. (A copy of Section R of the Corporation's "Manual of Examination Policies" that relates to the examination of trust departments and a blank copy of a "Report of Examination of the Trust Department" are enclosed.) Minimum requirements for operation of the department are prescribed as outlined in the enclosed "Statement of Principles of Trust Department Management".

Inasmuch as the financial condition of a bank may be affected by losses resulting from dishonesty on the part of the general public and a bank's own employees, the Corporation is authorized, by subsection (e) of section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828(e)),

to require any insured bank -- whether it be a national bank, a State member bank, or an insured State nonmember bank -- to provide protection and indemnity against burglary, defalcation, and other similar insurable losses. Whenever any insured bank refuses to comply with such requirement, the Corporation is authorized to contract for such protection and indemnity and to add the cost thereof to the assessment otherwise payable by the bank for insurance of deposits. In determining the adequacy of fidelity insurance, the Corporation follows the schedule of coverage recommended by the Insurance and Protective Committee of the American Bankers Association, a copy of which is enclosed. Examiners are given specific instructions with respect to fidelity protection and internal routine and controls. Engagement in trust activities is among the factors which may dictate a need for insurance in amounts higher than those suggested by the American Bankers Association. We have experienced little difficulty in persuading banks to follow our insurance recommendations, and in no instance has the Corporation been called upon to purchase the coverage for a bank under the authority to which reference previously has been made. During the past ten years, special emphasis has been placed by the bank supervisory authorities upon the purchase by banks of excess employee dishonesty coverage, and a majority of the insured commercial banks have now purchased this extra fidelity protection.

Examinations conducted by the Corporation and the other Federal banking agencies of the insured commercial banks which they supervise, together with the protection afforded by fidelity insurance against losses resulting from dishonesty of a bank's own employees, assure the financial responsibility of banks subject to Federal regulation that act as administrators of employee welfare and pension benefit plans. Accordingly, a continuation of the exemption from the bonding requirements currently provided by the Secretary's regulations for banks and trust companies subject to Federal regulation may be warranted.

It is respectfully requested that this letter be made a part of the record in the proceedings in this matter before the Hearing Examiner at the United States Department of Labor, scheduled for August 12, 1968.

Sincerely yours,

K. A. Randall
Chairman

Enclosures

Ex 6

EXAMINATION OF TRUST DEPARTMENTS

FDIC

Foreword

This Section of the Manual is designed to provide explanatory material and to define the principles and methods of procedure for verifying the records and assets of the trust department. The material is presented in a general and non-technical manner to facilitate its use by examining personnel who devote their major endeavors to other phases of bank examination. In addition to familiarizing Examiners with the mechanical aspects of the examination procedure, it is desired to point out the responsibility attached to the conclusions which must be drawn by the Examiner and the importance of the recommendations to management leading to more effective control over the operations of the trust department.

The Trust Examiner is charged with the responsibility for determining acts (a) which have resulted in or may lead to losses or surcharges to the institution, (b) which are in violation of controlling statutes or regulations, or (c) which are not consistent with generally accepted standards.

A bank acts in a fiduciary capacity when the business which it transacts, or the money or property which it handles, is not its own or for its benefit but belongs to another and is for the benefit of others. This relationship necessitates great confidence and trust on the part of the customer of the bank and places a high degree of good faith and responsibility on the bank. A bank acting as a fiduciary incurs a liability which is measured by what it receives and is discharged from that liability only by the proper application of what it receives to the objects for which, or persons for whom, it is received. The Examiner must determine that management discharges the fiduciary obligations accepted without jeopardizing the assets or earnings of the fiduciary, and has the ability and capacity for this responsibility.

The end objective of the Examiner is to convey through his report a clear, concise and logical picture of the department and of his analysis and appraisal, plus the results of the effectiveness of his discussion of these matters with management. Regardless of how skillful the Examiner may be in making an examination, or how effectively he analyzes and appraises the overall situation, his efforts are nullified to the degree that he fails in conveying through his report a lucid and integrated portrayal of the department in proper perspective.

Paramount, therefore, among the Examiner's responsibilities is preparation of a report in such a manner as to convey clear and inescapable conclusions to the bank's board of directors and the supervisory authorities. Of equal importance is his dealing with management. Effectual salesmanship is one of the most desirable results of his efforts. It is much more desirable to present his recommendation to management in such a manner that it will be accepted during the examination than to depend upon formal supervisory action.

DEFINITIONS AND DUTIES OF INDIVIDUAL TRUST ACCOUNT SERVICES

The services defined below are those most commonly encountered, and the duties indicated may be described as "usual." The duties normally accompanying the acceptance of the described capacities may vary in the several States. For this reason, they are briefly described in general terms. In order to gain a complete scope of the responsibilities of a given fiduciary capacity it is suggested that the Examiner familiarize himself with the applicable State statute.

Executor - An executor is named in a will to settle an estate and to perform in any other manner described in the will. Before a bank acts as an executor, it must first have the will accepted by the court of probate as the valid and final will of the deceased and it must then receive written authority from the court of competent jurisdiction to serve as executor. Only then is the bank duly endowed with all the powers and authority given in the will and may then exercise them to the extent that they are not in conflict with the law.

The main duties of the executor include: (1) The preparation of an inventory of all assets of the deceased; (2) the taking of control or custody of such assets; (3) the orderly conversion of such assets to cash, unless the will provides for the distribution of certain assets "in kind"; (4) the payment of administration costs, taxes and all other claims according to law; (5) the distribution of the net remaining estate in accordance with the terms of the will; and (6) the filing of a final accounting with the court of jurisdiction if required by the will.

<u>Administrator</u> - An administrator is appointed by the court to settle the estate of a person who has died leaving no valid will. The chief difference between the duties of an administrator and an executor lies in the responsibility of the administrator to manage and to distribute the property according to the laws of the particular State involved, whereas the executor manages and distributes the property in accordance with the provisions of the will.

<u>Administrator with the will annexed</u> - The court appoints an administrator with the will annexed when no executor has been named in the will or when the executor named has died or is unable or unwilling to serve. The duties of an administrator with the will annexed are the same as those of an executor and distribution of the property is made in accordance with the terms of the will.

<u>Trustee under will</u> - A trust under will is created when the maker of a will leaves any portion of his estate to an individual or bank as a trustee for a person, corporation, or charitable organization rather than leaving the property outright to any of these beneficiaries. The trustee receives the property from the executor or administrator with the will annexed, administers it for the benefit of the beneficiaries named in the will, and makes the ultimate distribution directed in the will.

<u>Trustee under agreement or by declaration</u> - A trust under agreement comes into existence when the creator of the trust enters into an agreement or contract with the trustee setting out the terms of the trust. A trust by declaration is created when one declares himself trustee of property for someone else. Duties are those specifically set out in the agreement or declaration and may include a wide range of responsibilities.

Pension trusts are established by an employer, commonly a corporation, to provide benefits for incapacitated, retired, or superannuated employees. Instead of operating its own plan, the corporation may create a trust and deliver cash or other property to the trustee who, according to the terms of the agreement purchases annuities immediately or upon retirement or disability, or may administer the property as a trust estate.

<u>Trustee by order of court</u> - A court of proper jurisdiction may appoint a bank trustee to receive property in trust and to administer it for the benefit of the person or persons designated. Many trust relationships so established are in the nature of a guardianship and in some States the capacity is known as a guardianship rather than a trusteeship. Often, the court appoints the trustee for a special purpose arising from litigation in court. In divorce proceedings or real property disputes, for instance, the court may appoint a trustee to take over, hold, obtain income, or dispose of the property and account to the beneficiaries pending settlement of the dispute.

<u>Guardian</u> - A guardian is appointed by a court but his authority and duties are conferred by the State. The guardian of a minor receives, holds, and manages the property, makes a full accounting to the court, and makes final settlement with the minor when he becomes of age. A guardian for an incompetent or absentee performs the above described duties as long as the incompetency or absenteeism lasts. Such words as committee, conservator, curator, and tutor are used in various States to describe particular kinds of guardianships.

<u>Agencies</u> - A bank acting as an agent should always operate under a written agreement with its principal and confine its activities to those specifically authorized by such agreement. There are many kinds of personal agencies where a bank may serve as agent for the principal and include the following most commonly

found in banks: (1) custodian, (2) escrow agent, (3) managing agent, (4) attorney-in-fact, and (5) safekeeping.

When serving as custodian, the bank has only the duties of safeguarding the property involved and of performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. For example, in the exercise of custodial duties involving securities, the bank may be required to collect income and principal, notify the principal of defaults, called securities, stock rights for purchase, etc., and execute owners' orders to buy, sell, etc.

In its capacity as escrow agent, a bank has the responsibility of holding the assets and other documents delivered into its custody until the conditions for their release to a third party have been fulfilled in accordance with the terms of the escrow agency agreement. Thus, to its custodial duties are added the responsibilities of seeing that the conditions specified by the principal in the escrow agreement have been fully met in the manner intended before the assets and other documents are delivered to the third party specified. This makes the bank liable for its actions, not only to its principal, but also to the specified third party.

As managing agent, a bank may exercise varying duties and responsibilities due both to the nature of the assets to be managed and to the degree of the management functions assigned the bank in the terms of its written agreement with the principal. For example, as managing agent for a securities portfolio, a bank may have custodial responsibilities, may make recommendations for the purchase and sale of individual securities and the income therefrom, and may receive and disburse collections of income and principal in conformity with approval of the owner. Also as related to real property, the bank as managing agent may rent the property, may attend to its upkeep, its insurance, and its taxes, may collect and remit the rental income; and may develop or sell the property. The principal distinguishing feature between a trust agreement and a managing agent agreement is that the bank exercises its authority under a trust agreement usually independent of the entrustor or the beneficiary but must secure the approval of the principal in a managing agency to its recommendations involving the exercise of judgment before execution thereof.

A bank becomes an attorney-in-fact when it receives a formally executed power of attorney, which may be recorded as a public record. Usually, but not always, there is a written agreement defining the areas in which the bank may serve as an attorney-in-fact for an individual and without such limitation, the bank may do anything as an attorney-in-fact which the person could do on his own initiative. An attorney-in-fact authority may be used by a bank to vote stock, sign proxies, collect debts, convey real property, transfer personal property, or perform a multitude of similar services for the principal.

A bank performs safekeeping duties when it accepts property for safekeeping only and delivers the property to the principal at his direction, with no ministerial action being taken during the period of safekeeping.

DEFINITIONS AND DUTIES OF CORPORATE TRUST ACCOUNT SERVICES

As in the case of individual or personal trust account services, a bank may serve as a corporate trustee or as a corporate agent. The following are among the classes and types of corporate trust account services most frequently encountered in the trust department of the bank.

Corporate trustee - The document which creates the corporate trust is variously called a mortgage, a trust mortgage, a deed of trust, a trust agreement, a debenture agreement, a collateral trust agreement, a trust indenture, or simply an agreement or an indenture. Most such indentures arise as the result of the endeavor of a corporation to raise money through a bond or note issue. In order to insure evidence of satisfactory collateral and to make the debt issue more attractive to the potential lender, the borrowing corporation appoints the bank as a responsible, disinterested trustee to whom title to the security is transferred to hold in trust for the benefit of the lender. Since many lenders may

participate in furnishing the borrowing corporation the money it desires, bonds, notes or debentures are issued in denominations suitable for their ready sale and such obligations must bear the authentication of the bank as trustee. Thus, all lenders share proportionately in the collateral held by the bank as trustee and in the other rights given by the indenture. The indenture provides further that the bank serving as trustee exercises certain duties in the event the borrower defaults. In this event, the bank enforces all the rights of the lender against the borrower creating the trust

Transfer agent - A bank may act as transfer agent for a corporation in effecting the transfer of the stock, voting trust certificates, certificates of deposit, and bonds and other debts of the corporation from one owner to another. Most of the transfer agencies performed by banks, however, concern the stock of the corporation. The transfer of stock involves not only the bookkeeping duties of recording the change in ownership but the decision as to the legality of the assigner's right to transfer to the new owner and it is this latter responsibility that calls for the exercising of sound and accurate judgment by the bank. Although the bank functions as the agent of the corporation, it also serves to protect the interests of the individual shareholders and other creditors of the corporation.

Registration agent - As registrar, a bank checks every new stock certificate prepared for issuance by the corporation or its transfer agent against the old certificate being cancelled to make sure that the number of shares surrendered equals the number of shares to be issued and thus the primary function of the registrar is to prevent the overissuance of stock. Since the registrar is a check upon the transfer agent, a bank cannot serve the same corporation in both capacities. A bank may also serve a corporation as registration agent for bonds and other debts of the corporation. As registrar, a bank has less difficult and intricate decisions to make than if it serves as transfer agent.

Fiscal or paying agent - In its capacity as fiscal agent for corporations, a bank makes interest payments on coupon bonds as the coupons are presented and pays off maturing bonds and notes. It files ownership certificates with the government and may also make out and mail dividend checks. The fiscal agent is variously called disbursing agent, dividend disbursing agent, coupon and bond paying agent, or some similar name indicative of the duties with which it is especially charged.

Depositary - Banks are frequently called upon to serve as depositaries in the event of defaults and in connection with mergers, consolidations, reorganizations, and other transactions in which it is necessary that such items as outstanding bonds or notes or stocks be deposited with a responsible and disinterested party. The depositary may also receive and record the claims of creditors.

DEFINITIONS AND DUTIES OF EMPLOYEE, COMMUNITY AND INSTITUTIONAL TRUST ACCOUNT SERVICES

Employee trusts - Among the purposes for which corporations establish employees' trusts are the following: (1) To provide for employees who become incapacitated before retirement age (2) To provide for employees who retire; (3) To enable employees to share in the profits of the business; (4) To enable employees to participate in the ownership of the corporation; (5) To encourage thrift and savings among employees, and (6) To reward employees for meritorious service. The three principal types of employees' trusts designed to serve one or more of these purposes are pension trusts, profit sharing trusts, and stock bonus trusts.

A bank may be called upon to serve under these employee trusts as trustee or co-trustee, agent, depository, or custodian. The duties of the bank and whether or not it has any investment responsibility would depend upon the terms of the instruments creating such trusts.

In order to furnish economic data, etc., all employee trusts are to be segregated in a separate liability designation to be typed in on the statement of personal trust department.

Pension trusts - Pension plans may provide for employees as a group, or they may treat the case of each employee separately. For example, a group annuity contract or an individual annuity contract may be purchased from an insurance company for the benefit of each employee. Also pension trusts are either contributory or non-contributory with regard to the employee sharing a portion of the cost of the plan.

Any trust established by an employer to provide benefits for the incapacitated, retired or superannuated employees, with or without contribution by the employees, is known as a pension trust. The three principal types of pension trusts are distinguished as follows: (1) The corporation makes payments to the bank which are then immediately used by the bank to purchase individual annuity contracts from an insurance company; (2) the corporation makes payments to the bank and the bank invests the funds until the employee becomes eligible to receive the benefits when the share belonging to him is used to purchase an annuity insurance contract; and (3) the corporation makes payments to the bank and the bank invests the funds and when the employee becomes entitled to receive the benefits, makes payments to him of such benefits. It is readily apparent that the bank's degree of responsibility increases in the order listed.

Profit sharing trusts - The essential difference between a pension trust and a profit sharing trust is that in the former the corporation sets aside the funds necessary to provide a previously determined amount of retirement income, whereas in the latter the amount of retirement income depends upon the earnings the corporation is able to place in the trust from time to time before the participating employees retire. The terms of the agreement and the procedures, duties and powers of the bank in a profit sharing trust are in many respects similar to those of a pension trust.

Stock bonus trusts - This type of trust is usually established to reward the meritorious service of employees or to assist the employee to acquire an ownership interest in the business. Stock bonus trusts thus differ from profit sharing trusts in that the former gives the employee part ownership of the business whereas the latter gives the employee a share of the earnings of the business but not an ownership interest.

Community trusts - A community trust is a trust composed of gifts and bequests made by the citizens of a community for the benefit of the people of the community, with community being used in the sense of any area of land. Accompanying the advantages of a community trust in handling the entrustor's funds to the maximum benefit of the people of the community, is the need for wisdom and careful propriety on the part of the bank in distributing the benefits.

Institutional trusts - Included in this category of trust services are trusts for the benefit of higher educational institutions, hospitals and other public natured organizations devoted to education, the arts and the sciences, such as art galleries, symphony orchestras, libraries, etc. Whereas in the case of community trusts the beneficiaries are varied and often unspecified, institutional trusts are created for the specific benefit of the object served by the institution. The responsibilities of the bank may range from limited agency to full discretionary trust management.

OPERATING AND ACCOUNTING RECORDS

The books and records of trust departments will naturally vary with different banks. An adequate set of trust records for every bank with a trust department, be it large or small, will include the following common essentials: (1) A completely separate set of books and records will be maintained for the trust department apart from any other records of the bank; (2) the trust records will reflect full and current information on each trust account serviced from its initial opening to its final closing; (3) the trust records will be so kept that the individual trust accounts may receive prompt and adequate supervision by the bank, and (4) the trust records will reflect all management supervision accorded. Trust department records, therefore, should be as detailed and comprehensive as are necessary to meet the above requirements, but they also should be no more elaborate than necessary in order to preserve efficiency and economy. Examiners should maintain a reasonable and sensible approach to recommended changes in trust department records, to the end that they are both adequate and efficient.

Generally, trust department records may be divided into three categories: (1) Trust officers' dockets; (2) records relating to the control of total assets and liabilities; and (3) records showing detailed information with respect to individual accounts.

Docket or Trust History Record - This subsidiary record is sometimes referred to as a docket, trust history, digest, synoptic record, abstract sheet, or administration folder, and is one of the most important records in the modern trust institution. This type of subsidiary record contains much pertinent information and can be of great value to administrative officers and examiners alike. If properly and carefully maintained, it will reveal among other things: (1) Trust number, (2) full title of account, (3) names and addresses of all interested parties, including life tenants and remaindermen; (4) date of trust agreement and amendments thereto, or date will was admitted to probate; (5) general and special powers of the fiduciary; (6) rates of commission on principal and income; (7) digest or synopsis of the will or agreement and amendments with particular emphasis placed on the investment provisions; (8) dates of birth of minors; (9) date trust terminates, if ascertainable, (10) dates of death of persons in interest; (11) indemnity agreements, particularly with respect to the purchase or retention of investments; (12) names of co-fiduciaries and others with whom it may be necessary to consult; (13) list of the original assets (not including changes made by trustee) including the chargeable values and dates received; (14) list of debts and dates paid; (15) in chronological or diary fashion, a brief digest of important letters, legal opinions, conversations, understandings, arrangements, subsequent agreements and other important events.

Records relating to the control of total assets and liabilities

Journal - Of the records relating to the trust department's total asset holdings and total liabilities, the journal, or original entry record, requires the greatest amount of thought in design and care in maintenance if it is to prove satisfactory in operation. The journal, regardless of form, performs three functions: It furnishes the figures which are to be posted to the general ledger; it provides the basis for the entries which must be made on all other records affected by each transaction; and, it provides a chronological record of all of the day's transactions.

General ledger - The general ledger carries the control accounts of the department and gives a complete picture of its liabilities and asset holdings.

Asset control accounts - These sheets contain a detailed record, arranged as to trusts, of all items of investment. The records are subsidiary to the general ledger as the general ledger is generally posted by totals only. In the larger departments, separate sheets are used for various types of investments, such as stocks, bonds, mortgages, real estate, deposits and miscellaneous, and where this is done a separate control account is carried on each type for all trusts. The total assets of any given type, as carried on the asset sheets, should equal the total of the same item on the general ledger or control.

Records showing detailed information with respect to each account

Principal or investment control account - This account is generally a summary of the individual investment ledger sheets and represents the total invested principal of each trust account. However, principal cash, both invested and uninvested, is often included, so as to reflect the total assets of the trust.

Cash ledger - The cash income and cash principal accounts are two separate chronological accounts, each of which shows cash receipts, disbursements, and balance for each account.

Investment ledger - In the smaller departments, investments may be found consolidated on a single ledger sheet for each account. With investments changing during the life of the account it becomes readily apparent that to avoid carrying closed out entries in the active records and to simplify audits and the work of checking securities, investment ledger sheets which show only one kind of stock, bond, mortgage, parcel of real estate, or other asset to a page are considered more desirable.

DUTIES OF THE TRUST DEPARTMENT EXAMINER

The principal responsibilities of the trust examiner are set out in the foreword to this Section of the Manual. In addition to the duties which are basic to the examining function as related to an examination of the commercial department of the bank, the following duties are peculiar to the examination of a trust department and include the responsibility to:

(1) Ascertain that all trust assets are intact or properly accounted for.

(2) Make certain that the fiduciary accounts are being managed in accordance with the fiduciary agreement and in conformity with statutory requirements.

(3) Determine that assets held are conforming with law and agreement.

(4) Ascertain that a periodic review of all the assets in each trust has been made to determine whether individual assets should be retained or sold and that such review has been satisfactory in scope and duly considered by composite judgment.

(5) Determine that important trust matters are receiving appropriate consideration by the board of directors of the bank or by a designated trust committee.

(6) Ascertain that trust cash awaiting investment or distribution has not been held longer than reasonably necessary, or legally permitted.

(7) Verify that income earned on the assets is received and properly accounted for.

(8) Account for the distribution of income and principal and determine that such distribution is in accordance with the agreement and the statute.

(9) Determine and report any self-dealing activities.

(10) Account for the income accruing to the bank from the operation of the trust department.

In the large departments, a complete, detailed check of all of the above items would be so time consuming as to not be in proportion to the value to and purpose of the examination. A review of the internal routine system in operation may reveal a well organized department having a good system of internal control. In this event, the Examiner may, at his discretion, direct an examination of the assets and a partial or spot check of the other facets of the examination. Reference is made to the topical heading, "Scope of the examination," discussed later in this Section.

EXAMINATION PROCEDURE - PERSONAL TRUST DEPARTMENT

Control - At the opening of an examination it is sometimes impracticable to start work on the trust department until assistance has been given Examiners in the commercial department. In such cases, trust assets should be immediately sealed and a notation made of the last entry on the trust ledger. The ledger may then be released. If it is necessary to post the records to bring them current to the date of the examination, the Examiner should check the postings for possible irregularities.

An immediate determination of any intermingling of trust department assets with those of the commercial department must be made, and extreme care should be exercised in guarding against interdepartmental and interfiduciary substitution of assets.

It is also desirable at the beginning of an examination to obtain a record of all securities for which the bank has accepted accountability but which have not been recorded on its books and some of which may not be in its possession.

Usually, all cash received is deposited daily. Consequently, the only cash on hand should be the current day's receipts or a cash fund placed in the trust department by the commercial department. If it is the custom to carry a cash fund, it should be immediately controlled and verified in the same manner as other cash funds.

<u>Verification and reconcilement of due from bank accounts</u> - The laws of most States permit a trust department to carry its uninvested funds on deposit in the commercial department. Some departments carry their trust cash in other banks. In either instance, the "due from" cash account must be verified in the same manner as that followed in connection with correspondent banks.

If the bank account is carried in the commercial department of the same bank, most of the checks which were considered outstanding in the reconcilement will have been paid prior to close of the examination. These should be obtained and checked against the reconcilement. Checks which have been outstanding for some time should be investigated and a determination made as to the reason for non-presentment. Note should also be made of the length of time the checks have been outstanding in order that items which may be unclaimed funds or abandoned property will be reviewed for adequacy of attention by the management.

The Examiner should note that the accounts are reconciled at periodic intervals, and that the examination of cancelled checks or vouchers and the reconcilement effected, reviewed or approved, by some person other than the one responsible for the original entry.

<u>Verification of trust assets</u> - As the assets are under seal, the Examiner should check them as early as practicable so as not to cause undue inconvenience to the bank. The technique employed in determining that all assets recorded on the bank's records are accounted for is at the discretion of the Examiner. Normally, the verification can be expedited by checking directly to the bank's asset sheets. Under other circumstances it may be considered desirable to schedule assets on a "spread sheet" prior to checking, or the bank's system of recording and storing stocks, bonds, and the documents representing other assets may dictate transcribing the information to the trust line cards, FDIC Forms Numbers 74 through 78 described later in this Section. It must be remembered that the verification described above involves only checking the assets to the bank's records. It may not always be practicable to check the assets of each trust to the original inventory, or agreement, and to follow through changes as they occur. In the smaller departments, at least each new trust accepted since the last examination can be examined to determine accurately that the original corpus was entered properly on the records and placed under proper control. In the larger institutions, time limitations may prescribe such complete determination only on a segment of the trust accounts.

In the process of checking the trust assets against the records of the bank, the Examiner should also verify that:

(1) All assets in the vault of the bank and all other important trust papers are exhibited to the Examiner, and are accurately described and identified on the trust records to which verification is being made.

(2) Assets not in physical possession of the bank are properly accounted for, are protected against loss hazard, and are controlled by the bank.

(3) Registered bonds, stock, notes and other documents evidencing ownership of assets are registered in the name of the bank as fiduciary or in the name of the nominee.

(4) Assets are being accorded proper servicing and adequate protection. For example, on coupon bonds, the coupons due should have been separated from the bond and presented for collection but unmatured coupons should still be attached to the bond. Real estate mortgage notes should be supported by evidence of merchantable title of debtor and first lien status of the note held by the trust, and of adequate insurance protection. Taxes and other assessments constituting prior liens against the property should be determined to be not delinquent.

Verification of collection of income on fiduciary accounts - A complete record should be made of all of the income received on trust accounts. The Examiner must satisfy himself that the trust department is properly recording all income received and is adequately checking the receipt of such income, not only to prevent dishonesty but to eliminate error.

Proof of the subsidiary records to the general ledger should be effected. The detailed verification of the items of income depends upon the size of the department and the effectiveness of accounting practices of the bank in controlling all income. Where conditions warrant, "spot-checks" of income earned on the fiduciary accounts may be made. Whether "spot-checks" are conducted or a more complete verification is carried out, the auditing technique employed would involve determination of income amounts and dates from the asset records and the tracing of the actual collection from the receipt thereof through the books of original entry to the general ledger.

Disbursements and payment of expenses - All disbursements and expense payments should be made by distinctive check or voucher. Since improper distribution or payment of the funds of the fiduciary account may result in loss to the bank, this phase of the examination demands close checking by the Examiner to determine that disbursements and expenditures are made in conformity with the fiduciary agreement and with the statute. For example, both the agreement and the statute may have to be examined to determine the manner in which special dividends, stock dividends, etc., are to be allocated as between principal and income in cases where the income and principal beneficiaries are different or where only income is available for distribution.

Overdrafts or advances to fiduciary accounts - Overdrafts or advances to the account occur whenever disbursements exceed the cash balance of either the principal or the income account. While in the ordinary course of affairs there should be no overdrafts, they do occur at times and with good reason. When found, they should be shown separately as overdrafts on the asset side of the personal trust department statement. Frequently, a reserve will be established against overdrafts or advances. Such reserves should be reflected as a liability, rather than a deduction from the asset account, in preparation of the personal trust statement.

Each overdraft should be investigated and the reasons for granting it ascertained, particularly in the case of principal overdrafts. Examiner should satisfy himself that the overdraft or advance will soon be corrected from anticipated cash income or principal. Overdrafts which have existed for a period of over three months should be listed in the report with appropriate comment unless there is a valid reason for their being carried, and any evidence of habitual or of indiscriminate granting of overdrafts should be a matter of criticism by the Examiner, for such practices may cause financial loss to the bank.

PREPARATION OF INDIVIDUAL TRUST WORK SHEET FORMS FOR PERSONAL TRUSTS

The material called for on the several trust work sheet forms for personal trusts has been selected because it is basic both to the accounting control and to the review of the administration of the individual accounts. It furnishes a summarized history of the account in addition to a listing of its current principal and income assets. From a review of the data presented, the Examiner can evaluate the correctness of the administration of the account and the probabilities of exposure of the bank to liability.

Form 77 - Personal Trust Sheet - A trial balance should be taken of the trust ledger showing the principal and undistributed income held for each account. The totals should agree with the controlling accounts carried in the general ledger.

The totals of income, invested and cash and principal, invested and cash, may be first transcribed to Form 77. There may then be effected a simultaneous proof of the bank's subsidiary records to the general ledger and the accuracy of the Examiner's transcription.

An important adjunct to the use of Form 77 as a media for the proof of corpus is in the compilation of miscellaneous information necessary to the examination and analysis of individual personal trusts. The form provides for a definition of the type of trust relationship involved, which information is especially useful in providing a breadown for TCT-5, "Statement of Personal Trust Department", it requires some comparison of the original inventory with the corpus at date of examination, and, the reverse side of the form provides a continuing record of the specific powers granted under the terms of the will or agreement and the detail of the requirements of proper management.

Form 75 - Stock, Bond, and Miscellaneous Investment Sheet - It has been previously pointed out that the work sheet forms may be employed in the verification of trust assets. Also mentioned was the limitation imposed on the use of these forms by the size of the department. Regardless of the Examiner's judgment in regard to the extent of the use to which the work forms may be placed, he may decide to completely fill out the work forms on at least the accounts on which a complete analysis will be made.

Form 75 may be employed in providing an asset breakdown for the "Statement of Personal Trust Department" in the Report of Examination. This form is also valuable in that it provides a continuing record of in and out transactions, a comparison of book, inventory, and market values which is helpful in determining prudence of management, and a means of recording for later use the conformance of a purchase to either legal requirements or the terms of the trust.

In listing or checking the items care should be taken to see that the exact name of the bond or stock is obtained. Different securities issued by the same company may bear somewhat similar names but have widely different values. If the more valuable bonds have been taken and those of lesser value substituted, this exact checking of the description of the securities will reveal the fact.

All securities not on hand at the time of examination, which may not have been delivered, sent out for sale or deposited with a protective committee, should be verified by direct correspondence in a manner similar to that followed for the bank's own securities.

Form 74 - Mortgage Investment Sheet - In the inspection of mortgages held for the various trusts it should be observed that all mortgage investments made by the bank are drawn or assigned in such a manner as to identify them as trust assets. The total of mortgages examined should equal the balance in the mortgage account in the general ledger, while the individual items of each trust should also be accounted for. Those not on hand should be verified by direct correspondence.

Except on mortgages turned over to the trust department at the time of the appointment all should be first liens and should be held in a fiduciary capacity. In addition, the mortgages should be accompanied by a brief of title, appraisal, and evidence that fire insurance is in force payable to the corporate fiduciary for the trust. The appraisals should be examined to note that they are in order and that the properties are re-appraised at intervals. The percentage of appraised valuation in making loans should be obtained and it should be noted that the amount of the mortgage does not exceed this limitation. It should also be ascertained that the payment of taxes and assessments is periodically verified. In general the same inspection should be made of the trust department mortgages as is made of the bank's own mortgages.

Form 78 - Real Estate Investment Sheet - In the absence of directions in the trust instrument or of special circumstances, a bank should be extremely cautious in investing trust funds in real estate.

All parcels of real estate should appear on the books at some value. This should be done so that the verification of income, payment of taxes and insurance will be complete for all properties in the custody of the trust department. Deeds should be on file for all properties, and insurance should be in force for protection from all hazards.

EXAMINATION PROCEDURE - CORPORATE TRUST DEPARTMENT

Trustee for Bond Issues - In view of the fact that the corporate trustee's name is associated with that of the issuing company by reason of their close legal connection, the bank should not accept any trusteeship for a bond issue until a careful investigation is made of the bond issue and the financial stability of the issuing corporation.

In trusteeships for mortgage bond issues the mortgage is made to the trustee for the benefit of the bondholders and should be recorded immediately in each county where the land is situated. Both the original issue and subsequent re-issues are certified by the bank.

The Examiner should ascertain that the bank took steps to determine the legality of each corporate issue and that the necessary corporate procedure in connection with the appointment of the bank as trustee has been carried out by the issuing corporation.

Corporate indentures or deeds of trust are usually lengthy and voluminous documents. The general references should be made to the description of the property to be mortgaged, covenants of the company, action in event of default, the bondholders' rights, and the discharge of the trust. Examiners will be particularly interested in: (1) Provisions regarding redemption of the bonds; (2) terms of any sinking fund arrangements; (3) insurance requirements and the application of insurance funds collected; (4) the provisions for partial releases of property; and (5) the protection accorded the bank.

In addition to the indenture, there should be on file the original or a certified copy of the instrument creating the trust and the following papers:

(1) Certified copy of charter establishing the legal existence of the corporation.

(2) Certified copy of by-laws.

(3) Certified copy of the minutes of the meeting or meetings at which the execution of the mortgage and the appointment of the trustee was authorized.

(4) Certified copy of the minutes of the meetings at which the officers who sign the mortgage and bonds were elected.

(5) Specimen signatures of the above officers.

(6) Order of public service commission, or other body, having jurisdiction over the corporation in question.

The Examiner must determine that all securities turned over to the trust department have been accounted for. The engraver's certificate should show the total amount of bonds engraved and to whom delivered. Of the total issue delivered, the bank should have on hand the bonds themselves, whether certified or uncertified, cancelled bonds or a proper receipt therefor, or

cremation certificates therefor, or the issuing company's receipt for bonds delivered to it. The amount of bonds issued should be compared to the authorized amount to ensure the bonds have not been over-issued. When bonds have been paid, the bank should have on file the cancelled bonds properly perforated, the issuing company's receipt therefor, or a proper cremation certificate.

Collateral issues should be treated in the same manner as mortgage bond issues. The Examiner should check stocks and bonds, if they are a part of the collateral, and compare the same with the trust department's records. Such securities should be registered in the bank's name in its fiduciary capacity or held under a power of attorney. Substitutions, where authorized, should be examined to ascertain that collateral of less value than that originally placed in the trust is not substituted. Furthermore, if the trust instrument specifies that only certain types of collateral shall be held, the Examiner will list all collateral not of the required type.

In issues where the indenture requires a sinking fund, the Examiner will determine if the provisions of the indenture are being carried out. Cash should be verified and, unless it can be determined from the agreements on file, the amount that should be in the sinking fund should be determined by correspondence. If the trust agreement permits the bank to invest the sinking fund, the Examiner will ascertain that it is invested in the securities authorized by the agreement and that the proper amounts are on hand. Sinking fund investments and collateral held must be included in the "Summary of Securities Held as Corporate Trustee or Corporate Agent" on Report of Examination Form TCT-6.

Agency Division of Corporate Trust Department - The bank may be called upon to act as fiscal agent of a corporation in the paying of interest or dividends. In such cases the corporation deposits the necessary amount of funds with the bank and the bank issues its checks in payment of the interest or dividends. When bonds are fully registered a check is sent to the holder of record, while in the case of coupon bonds the coupons are presented for payment.

The amount deposited by corporations for the payment of interest or dividends should be scheduled, and charges against such deposits should be verified by checking receipts for the return of cancelled coupons and checks, and paid coupons and checks on hand. The difference represents outstanding items and should equal the total amount on deposit at the date of examination.

Another service rendered by banks is that of acting as registrar and transfer agent. However, these functions should not be exercised by one bank for the same corporation. A transfer agent examines the transfers, gives good title and maintains a full and complete record of the shareholders. The registrar keeps the official record showing the issuance and cancellation of stock certificates, thus preventing issuance of stock in excess of the amount authorized.

The transfer agent must exercise due care in the transferring of stock certificates, particularly when the stock is held by one in a fiduciary capacity. Before transferring the certificate in such cases the bank should have certified copies of the will or trust indentures, and in court trusts where there is no will annexed orders must be obtained before he will be justified in transferring certificates

The bank should have on file, and if not the Examiner will so report, a certified copy of the charter and by-laws, certified copy of the resolution of the corporation's board of directors appointing the bank as transfer agent and specimen signatures of officers authorized to sign the stock certificate.

In acting as a depositary under plans of reorganization, the corporate agency must keep full and complete records of all deposits received, in whatever form, and, upon completion of the reorganization, issue to the depositors new securities or cash, or return the old securities bearing appropriate endorsements against surrender to the bank of the certificates of deposit. The Examiner should ascertain that such deliveries are being properly made, that the certificates of deposit or receipts are properly cancelled, and that proper records thereof are maintained

The Examiner will determine if the safe-keeping division of the trust department maintains sufficient records and adequate controls. Articles left for safekeeping should not be commingled with the bank's assets but should be properly earmarked as well as being amply protected by insurance.

In escrow accounts documents, money or securities are usually delivered to the bank by one or more parties to be turned over to a certain person or persons upon the fulfillment of certain conditions set forth in the escrow agreement. Care should be taken to determine that the bank, as escrow agent, assumes no undue liability under the terms of the agreement; that its duties and obligations are clearly set forth; and that it is not placed in the position of arbitrator. The assets called for by the agreement should be verified.

Form 76 - Corporate Trust Work Sheet - The face of this form provides for the necessary reconcilements and accumulation of data discussed previously in this Section, and the reverse side when completed will furnish a digest of the indenture which, once compiled, is good for the life of the trust. The time that this saves after the first examination is very great, and on the subsequent examinations, it will be a simple matter to determine just what should be inquired into and done.

PREPARATION OF REPORT OF EXAMINATION OF TRUST DEPARTMENT

Page numbers have been omitted from the printed TCT forms of the Report of Examination. Upon completion of a Report, the Examiner must insert page numbers in consecutive order at the bottom of the page. The schedules should normally follow the order delineated in the Table of Contents, FCT-1. Form FCT-1 is for the use of the Field Examiner only. Form TCT-1, a blank page, will be employed by the typist in the District Office in the preparation of the Table of Contents in the finished Report of Examination.

Where a department is small or free from criticism the finished Report may consist of but a few pages. The basic pages may be said to include:

Conclusions and Recommendations	TCT-2
Statement of Personal Trust Department	TCT-5
Trust Officer's Questionnaire	TCT-7
General Information	TCT-8
Page A, Confidential Section	TCT-24

While the supporting schedules should be used freely where applicable, they should be employed only if meaningful.

Conclusions and Recommendations (TCT-2) - This section of the Report has been purposefully placed immediately following the Table of Contents to command the closest attention of the management. As in the commercial Report of Examination, the Examiner's comments on this page should be phrased carefully and, so far as possible, listed in the order of importance.

To be most effective, the Examiner's comments should be brief and to the point. Reference to schedules supporting conclusions should be freely made and data may be excerpted from other schedules for inclusion in the Examiner's conclusions and recommendations.

When a criticism is made by the Examiner, he should make such constructive recommendations as will enable the bank to correct the exception complained of. A criticism without a definite recommendation for correction leaves the bank in many cases at a loss to know just what the Examiner has in mind, and may entail unnecessary correspondence between the bank and the supervisory authority.

Reference is made to instructions in the Manual of Examination Policies, Section C, "Conclusions and Recommendations."

Recapitulation of Contingent Liabilities, Potential Losses, and Estimated Losses (TCT-4) - This schedule may be considered a summary of the Examiner's findings with respect to liabilities which may have to be absorbed by the bank. The definitions which appear at the top of the page are for the benefit of both Examiner and banker and should be studied carefully.

The titles of supporting schedules in the Report that set forth in detail contingent liabilities, potential losses, and estimated losses, should be inserted on this page, together with the totals shown in the supporting schedules. The totals of this recapitulation should be carried forward to pages 1, 3, and 10-a of the Report of Examination of the Commercial department if a simultaneous examination of the commercial department is being conducted. Estimated losses and advances or overdrafts classified Doubtful or Loss will be carried forward to the capital account analysis on page 3 of the commercial report. A preferred treatment would be to write-in these captions under item (b) so as to distinguish the deduction from commercial department losses. Contingent liabilities and potential losses accruing from the examination of the trust department will be consolidated into similar commercial department items on page 1 and page 10-a of the commercial Report.

Statement of Personal Trust Department - Earnings of Trust Department (TCT-5) - The purpose of the statement of personal trust department is to establish the control features of the institution and to reflect the size and volume of accounts being administered.

Amounts entered should agree with the carrying values reflected on the books of the trust department. However, if the institution maintains both inventory and other control values, inventory values should be used for the purposes of this statement. Information to this effect should be recorded immediately following the statement wherein the basis on which assets are carried is detailed.

Sufficient blank space has been provided below "Advances or Overdrafts" for inclusion of additional figures or account segregations that may be necessary or desirable.

Similarly, the liability side of the statement calls for only two major liability segregations, but space has been provided so that a further breakdown can be inserted on such basis as appears desirable to the Examiner.

As stated earlier, all employee trusts, including bank and all other, are to be shown as a separate liability designation in the statement of personal trust department and should be typed in between "Agency, Custodian, Escrow, Safekeeping and Other Similar Accounts," and "Advances to Trust Department by Commercial Department," as follows:

All Employee Fiduciary Accounts
Number of Accounts____________

When the employee fiduciary accounts include self-administered bank employee fiduciary accounts, the above modification of the statement of personal trust department should be further amended with a footnote showing the number of bank employee fiduciary accounts and the amount at which they are reflected in the statement of personal trust department.

Provision has been made on Form TCT-5 for inclusion of the number of inoperative insurance trusts on hand and the face amount of the policies, and the number of inoperative wills on file. These facts should be accurately reported as they may be indicative of the growth possibilities of the department, and the aggressiveness of management in accumulating such contractual obligations.

The earnings schedule is self-explanatory. If the institution's records do not reflect the full information necessary to complete this schedule, such figures as are available should be shown. If the trust department function is of some consequence, management should be encouraged to maintain complete records of earnings, expenses, losses, and recoveries.

Trust Officer's Questionnaire (TCT-7) - This page, designed to expedite the work of the Examiner, should be presented to the trust officer immediately at the start of the examination. TCT-7-a is provided as a continuation page.

The Questionnaire is intended to inform the Examiner authoritatively and quickly on various matters, with particular emphasis placed on revealing sources of contingent liabilities or losses, and the existence of practices which may be considered unsound. When the answers indicate a condition not usually expected in the normal course of business, it will be presumed that unless specific comment is made by the Examiner, the matter has been investigated by him and the circumstances are such that in his judgment comment is not warranted.

Some of the questions ask for data since the previous examination. When the forms are used for the first time, the questions can be modified to whatever extent the Examiner deems advisable.

General Information (TCT-8) - It will ordinarily be found convenient and advisable to use this schedule in conjunction with the "Trust Examiner's Questionnaire" discussed later in this Section.

If a question on this schedule points to a practice or condition subject to criticism or extended comment, the Examiner's remarks should in most instances be included with the "Conclusions and Recommendations" rather than on this schedule, with an appropriate reference made to such treatment in answer to the question.

Attention is particularly directed to Questions 4, 5, and 6, which deal with the trust committee and the periodic analysis and review of trust assets. These questions are believed of more than usual importance and it should be determined that the responsibilities of the board of directors and the trust committee in these areas have been fulfilled. Management's responsibilities are commented on in detail later in this Section.

Trust Examiner's Questionnaire (PCT-28, 29, 30, 31, and 32) - This section of the Report is a work paper and should not be included in the completed Report. It is intended primarily to serve as a reminder and guide for the Examiner in reviewing the policies and practices of the department and their effectiveness. During the course of the examination, reference to the many questions contained in this section will usually reveal matters subject to criticism or comment. This section therefore should be of material assistance to the Examiner in preparing his criticisms, remarks, and recommendations.

In very small departments, extended reference to this questionnaire will as a rule be unnecessary in view of the inclusion of TCT-8 in the Report.

Other Schedules of the Open Section of the Report of Examination - Other schedules in the Open Section serve specific purposes and are believed to be self-explanatory. Conditions will be encountered from time to time which cannot be readily reflected on the regular schedules. In this event, it will be necessary for the Examiner to prepare special schedules and the blank page, TCT-23, may be employed for this purpose.

Confidential Section (TCT-24, 25, 26, and 27) - This section is in several respects similar to the Confidential Section of the commercial department report forms, particularly with reference to the information required on the management of the trust department.

In assigning a management rating, the adjective ratings of Good, Satisfactory, Fair, Unsatisfactory, and Poor employed in rating management of the commercial department should be used. The definitions of these adjective ratings set out in Section Q apply to the rating accorded the trust department, and the instructions contained in Section Q relative to preparation of the Confidential Section of the commercial department Report of Examination and management rating are to be followed in the preparation of the Confidential Section of the trust department Report. The duties and responsibilities of management as described below should be kept in mind when a management rating is established.

Trust examination procedure is not rigid or fixed, and the determination of the scope of the examination lies, in some measure, in the exercise of the Examiner's individual discretion. The Examiner is expected to broaden or restrict the scope in such manner as circumstances seem to require. Many details of the examination may be assumed to have been performed and need not necessarily be enumerated if such is the case. This would include such items as:

(1) Proof of cash and verification of cash subsidiary records with the general ledger.

(2) Proof of individual trust account totals and reconcilement with the general ledger.

(3) Physical verification or tracing of all trust assets.

(4) Investigation and analysis of overdrafts, advances, and large cash balances.

(5) Reconcilement of bank accounts.

If, however, the scope of any of the detail was limited in any respect, comment should be made to this effect. Generally, a resume of the scope of the examination should include a statement regarding any unusual procedures undertaken, and the extent of the review of the wills and agreements on new accounts accepted since the last examination, analysis of trust committee reviews since the last examination, completeness with which trust committee minutes were read, and the degree to which a survey of policies, practices, and procedures was conducted.

GENERAL INFORMATION

Contingent Liabilities

Certain definite rules of action governing trustees have been laid down by statutes and court decisions. A violation of any of those rules of conduct or a failure to carry out the terms of the trust instrument or court order will create a potential liability. Whether this liability is transferred from a contingent liability to an actual liability will depend upon the action of the parties.

A discussion of several types of contingent liabilities follows:

(1) Violation of Terms of Trust Instruments and Court Orders.

Where the terms of the trust instrument or a court order direct that a certain thing be done or prohibit the doing of a certain thing, the bank will be guilty of a breach of trust if it violates the terms of the instrument or court order. Should it be ascertained that by carrying out the terms of a trust instrument the estate will suffer a loss or hardship, application should be made to a court of competent jurisdiction for relief, but the terms of the instrument or order must be followed until modified by the court.

(2) Self-dealing.

A clear statement of law regarding self-dealing was expressed by the U. S. Supreme Court in Michoud v. Girod, 11 L. Ed. 1076, 45 U. S. 501, 4 How. 503:

> "The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity. It therefor prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because

his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells."

As such transactions may be set aside within a reasonable time after notice, at the instance of the beneficiary, the trust company may have to stand any loss by reason of depreciation or loss of income. The prohibition against self-dealing applies with equal force to affiliates.

Fiduciary funds should not normally be invested in loans to or obligations of directors, officers and employees of the bank and their interests. Any such loans or obligations found should be treated fully in the schedule provided on Form TCT-18. Any specific authority for acquiring or continuing to hold any such loans or obligations should be indicated. In the absence of specific authority to hold such loans or obligations received "in kind," bank has the obligation to obtain proper order to retain or to seek an early but favorable sale of these assets.

For the same reasons of propriety, a bank should not invest fiduciary funds in its own obligations or stock, or in the obligations or stock of its affiliates. When any such obligations are received "in kind," the bank should use due diligence in selling such assets at an early date unless it has or obtains specific authority from all interested beneficiaries to retain the assets in the fiduciary account. Examiner in reporting obligations or stock of the bank or its affiliates held in fiduciary accounts should reflect full details of the manner obtained, the period held, and the authority by which such assets are retained.

In determining whether a corporation or other business enterprise constitutes "an interest" of a director, officer or employee of the bank under examination to be reported by Examiner, the following general rules may be applied. If the connection of the director, officer or employee of the bank is merely nominal, if the director, officer or employee is connected in a minor capacity only, or if the director, officer or employee does not exercise any material control, the Examiner may, in his discretion, not include these loans or obligations in the schedule on Form TCT-18.

(3) Commingling.

The assets of each fiduciary account should be kept separate from both the assets of other fiduciary accounts and the assets of the bank, and there should be no commingling. In carrying out this responsibility, the bank should earmark all assets in the name of the fiduciary account. For example, mortgages, deeds, stocks, registered securities and obligations should be in the name of the bank, as fiduciary for the account, or in the name of the nominee. If the bank is acting in a capacity such as agent or custodian, registration would, of course, be in the name of the principal. In some States, however, a trustee may deposit uninvested trust funds belonging to several fiduciary accounts in a single deposit account in the bank administering the account or in another bank, provided the deposit account is designated as a deposit of fiduciary funds and the records of the bank administering the fiduciary account reflect the interest of each fiduciary account in the deposit balance.

(4) Legal lists, the prudent man rule, and conversions.

Many States have enacted statutes listing assets in which the bank may invest the funds of the fiduciary accounts. The Examiner will have to determine whether the statute merely permits the bank to invest in the named securities or requires the trustee to invest only in the named assets. If the statute is permissive rather than mandatory there does not appear to be any reason why the bank might not make investments outside of the approved list. However, if it does so it will be required to use the care of an ordinarily prudent business man.

The prudent man rule, or Massachusetts or American rule as it is variously known, generally applies in those States where there is no statutory list relating to the type of investments required or permitted by trustees. In the case of Harvard College v. Amory, the Supreme Judicial Court of Massachusetts said:

> "All that can be required of a trustee to invest is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested."

In some States, however, the Massachusetts Rule has been altered to specify that unless otherwise required by the terms of the trust, trust funds may be invested in such securities as an ordinarily prudent man of intelligence and integrity, <u>who is a trustee of the moneys of others,</u> would purchase.

Should the trust instrument direct the bank to make certain investments, although outside the statutory list, it will be liable if it fails to follow the terms of the trust instrument, unless the bank is relieved from complying with the terms thereof by a court of competent jurisdiction in an action wherein all of the necessary parties are before the court.

Unless there is a controlling direction by the settlor, by statute or court order, the bank is under a duty to convert "non-legals" into "legals" within a reasonable time after accepting the trust. This is limited to the extent that the bank may retain the investment for a reasonable time in order to obtain the best sales price.

(5) Real Estate Mortgages and Real Estate.

Loans secured by real estate mortgages or deeds of trust appear to be proper investments for trust funds in all States. The Examiner will determine from the statutes or decisions the limit that may be loaned on bonds or notes secured by real estate and if the loan exceeded the limit when made it should be reported.

Loans secured by second mortgages are generally disapproved by courts of equity and each such loan should be listed unless unusual circumstances exist.

In the absence of directions in the trust instrument or of special circumstances the bank should be extremely cautious in investing trust funds in real estate. The bank may, if directed to furnish the beneficiary with a home, purchase real estate rather than pay rent, but in such cases it should first obtain court approval. The bank may bid in property at a foreclosure sale in order to protect the beneficiary's equity, but if it does so it should dispose of the same as soon as a reasonable price can be obtained.

(6) Deposits with self.

Some States by statute or court decision authorize a bank acting in a fiduciary capacity to deposit uninvested trust cash in other departments of the bank for a reasonable length of time while awaiting investment. Other States have by statute or court decision adopted the equitable doctrine that a bank may not commingle trust funds with its own funds. Some courts have held that where a bank deposits trust funds with itself it is liable to the trust for interest at current rates. Where the bank is authorized to deposit uninvested trust funds in other departments, the Examiner will determine whether such deposits are to be protected by a pledge of security. If so, the Examiner will determine that the proper securities, both as to amount and type, have been pledged.

(7) Acts without consent or approval of co-trustee.

Co-trustees are joint tenants and must execute the duties of the office in their joint capacity. Where discretion and judgment are required, as distinguished from purely ministerial acts, the joint action of the trustees is required. A sale or purchase of securities is held to involve an exercise of discretion or judgment and requires the joint action of the trustees. The bank should have the written approval of co-trustees to the purchase or sale of all securities, and where such approval is not in the file the Examiner will schedule such assets.

(8) Failure to Invest.

Some States have by statute fixed the maximum length of time a trustee may keep in excess of a relatively small amount of trust funds uninvested and have prescribed that interest shall be paid on uninvested funds. It is to be noted that executors and administrators as a general rule are not authorized to invest the funds coming into their hands, and unless authorized to do so by statute should not invest the funds of the estate without the approval of a court of competent jurisdiction.

Unless the trust instrument or court order provides otherwise, a trustee is under a duty to invest. Should it fail to carry out this duty, it will be liable for loss of income, and if it were under duty to invest in a certain named investment it may be liable for the loss of the increase in value of the principal should the asset have risen in value.

<u>Common Trust Funds</u>

A common trust fund is a fund maintained by a bank or a trust company exclusively for the collective investment and reinvestment of money contributed to the fund by the bank or trust company in its capacity as trustee, executor, administrator, or guardian, and in conformity with the applicable State statutes or regulations of the appropriate authority. Such a fund is a means of centralizing fiduciary investments, particularly for smaller trusts, and for enabling wider diversification and closer investment supervision for a greater number of accounts. It also reduces the administration overhead and enables greater operating economy at no reduction in fees.

In the absence of a statute or regulation pertaining particularly thereto, the following observations are believed to constitute generally accepted practices regarding certain aspects of the establishment and administration of a common trust fund:

(1) The establishment and administration of the common trust fund should be in accordance with a written plan. This plan should be examined and approved in writing by competent legal counsel, and approved by resolution of the bank's board of directors. The written plan should include the investment powers of the bank with respect to the common trust fund, the allocation of income, profits, and losses, the terms and conditions governing the admission or withdrawal of participations in the common trust fund, the basis and method of valuing assets in the common trust fund, the basis upon which the fund may be terminated, and such other matters as may be necessary to define clearly the rights of participants in the common trust fund.

(2) Participation in the common trust fund should be at the direction of the trust committee after it has been determined that none of the common trust fund investments are illegal investments for a particular trust. Each party involved should be notified when the initial participation in the common trust fund is made.

(3) A valuation of assets should be computed at least every three months, and no participation should be admitted or withdrawal permitted except on the basis of such evaluation and on such valuation date. Any periods of grace subsequent to the valuation date should be established by the board of directors.

(4) The State statutes may require periodic accountings to a clerk of a particular court and/or the State supervisory authority. When not required by law or regulation, regular accountings should nevertheless be compiled for the common trust fund and made available to all parties interested in the fund. A good practice would be to make accountings coincident with an audit of the common trust fund.

On examination, the Examiner will accord the assets representing the investments of the common trust fund the identical appraisal and verification given assets held for individual accounts. Compliance with statutory requirements must be determined and the adequacy of the accountings established. The Examiner should satisfy himself that the investment and administration policies are consistent with current accepted practices.

Self-Administered Bank Employee Trusts

In establishing a plan for the benefit of its own employees, a bank exercising fiduciary powers has the choice of making the trust self-administered by the bank. While such a trust is in general no different from any other fiduciary account administered, the self-interest of bank management and of employees naturally present in any bank employee trust is such as to merit the special consideration of the Examiner.

It is a general axiom that a bank has a definite responsibility, moral as well as legal, not to deal with itself in the administration of a fiduciary account. The wise course for it to adopt, therefore, is not to deal with itself in any way, directly or indirectly, with respect to its fiduciary account, no matter how praiseworthy its motive might be or how beneficial to the interest of the fiduciary account a particular transaction might seem.

While this responsibility exists in every fiduciary account administered, the bank must seek ways in administering bank employee trusts of establishing safeguards against the possible moral and legal charge that its self-interest has been permitted to predominate over its integrity. For example, the fiduciary agreement should contain carefully drawn and explicit rules treating all elements of the conflict of interest. If it be the intention to invest the fiduciary funds in any direct or indirect obligation or interest of the bank, or of any of its directors, officers or employees, the agreement should be specific and detailed in this regard. Although armed with specific authority to invest the funds of the bank employee fiduciary account in its own stock, the propriety of its action is subject to close examination. Whereas it might be a definite part of the designed plan and to the benefit of the employees for the investment funds of a profit-sharing trust to be used to acquire stock of the bank, the investment of the funds of a pension trust in the bank's own stock might be self-interest to the degree of self-dealing. If the investment constitutes a sizeable portion of the fiduciary account, the question of adequate risk diversification exists.

Any element involving the question of self-interest and integrity of the bank should receive the special attention of the Examiner and should be disclosed in the examination report in the appropriate manner depending upon the circumstances involved. Where definite self-dealing is encountered, the Examiner should fully disclose the conditions in his report and should recommend to management that steps be taken to correct the situation. The Examiner obviously must exercise care and accuracy in his treatment of the cases involving conflict between self-interest and integrity and of any charges of self-dealing both in dealing with bank management and in his Report of Examination.

Board of Directors

The ultimate authority of and responsibility for the bank rests with its board of directors. The board of directors thus has the authority and responsibility for the trust department, and for the administration of fiduciary accounts from the decision to accept the account to its final closing. The bank, however, could not function effectively without the board of directors delegating authority and responsibility to committees of its own members, to its staff members, and to its legal counsel. The board of directors retains final responsibility for all delegated matters and in order to remain free of moral and financial accountability, they must maintain the proper degree of supervision of their delegated authority and responsibility. As related to the trust department and to trust administration, the board of directors can exercise the proper degree of control and supervision by: (1) Formulating policies for the guidance of the trust department in its administration of fiduciary matters; (2) requiring that it be kept informed concerning all trust matters through regular reporting by all committees; (3) considering as a composite body the important trust matters presented; (4) deciding or approving the actions to be taken or which have been taken relative to these important trust matters; and (5) conducting, or having conducted for it, a suitable audit of the operations of the trust department. Only through its written records can the board of directors demonstrate for all concerned that it is exercising its authority and responsibility in trust matters in a satisfactory manner so as to keep it free of moral and financial accountability. Consequently, the minutes of the board of directors should reflect consideration of and decisions reached with respect to all important matters, and on reports of all committees.

Where deficiencies or weaknesses exist in the discharging of authority and responsibility by the directors or in the proper recording of the actions taken by them, it is the duty of Examiners to inform the management of the bank of the importance of correcting the deficiencies and weaknesses in a manner which will relieve the bank of any charge of moral or financial liability, and to include such matters in the examination report.

Trust Committee

While a board of directors is responsible for the administration of fiduciary activities, for practical reasons it often appoints a trust committee to assist in this function. Discussed below are certain of the administrative responsibilities charged to the board of directors which may be delegated to a duly appointed committee:

(1) Accept new accounts. It is desirable that accounts be reviewed prior to acceptance in order to determine the workability of instrument provisions, the composition and nature of assets and any accompanying administrative problems, as well as the ability of the trust institution to adequately provide the fiduciary services required.

(2) Approve closed accounts. Closed accounts should be reviewed in order to determine that the bank's responsibilities have been properly discharged and that there is no further liability.

(3) Decisions regarding discretionary distributions, extraordinary expenditures and like matters. Discretion is one of the most important powers that can be vested in a fiduciary and it is believed that such power should be no further removed from the board of directors than its duly appointed committee.

(4) Approve investments. The committee is responsible for the purchase and sale and retention of investments. Whenever a bank has full and unrestricted power of investment or to the extent it has such power it has a twofold responsibility; namely, the conservation of the assets originally entrusted to its care or later acquired and the production of as good an

income therefrom or growth in value thereof as is consistent with safety. Investment skill is essential to the realization of these objectives. It is important to remember that legal or moral responsibility for the investment function cannot be delegated to investment counselors or any investment experts. However, their assistance is invaluable when internal investment skill is not adequate to the investment considerations involved. In any event, the committee and the board could not be expected to exercise prudence in retaining, acquiring, or disposing of assets for accounts unless full information concerning the items under consideration, as well as all details of the particular accounts, is at hand when investment transactions are considered.

(5) Review accounts. All accounts should be reviewed at least once in every twelve month period and more often as circumstances may require. The review should provide that the committee have before it for each account a synopsis sheet, a record of all assets with individual yields, and the amount of principal cash on hand. Appropriate records should be kept of the reviews with the directives of the committee recorded thereon.

In the performance of any of its functions, it is important that the trust committee clearly set out in its minutes any important matter considered and its conclusions in connection therewith.

Trust Officer

While the board of directors or its committee is responsible for fiduciary activities it is most always necessary to appoint a person to carry out many of the administrative functions. In view of the specialized nature of fiduciary business it is customary to place all detail operations under the active supervision of an executive officer whose responsibilities would include the following:

(1) Represent the bank in all fiduciary matters.
(2) Administer the various accounts.
(3) Report all matters to the trust committee requiring its attention.
(4) Execute policies and instructions of the board of directors and the trust committee.
(5) Maintain adequate records and controls.
(6) Protect all assets.

Legal Counsel

In view of the many legal problems that arise in connection with fiduciary relationships it is almost imperative for the bank to retain the services of competent counsel who will be readily available to pass upon fiduciary matters. The ability of the officers and directors to discern the instances in which legal assistance will be necessary, in order to avoid embarrassment and possible surcharge, is an important factor in successful operation of a trust department.

Size of the Trust Department

The size of the trust department, as measured by the assets and accounts it is servicing and the complexity of the trust administration, in no way relieves the management of the need to exercise its authority and responsibility in accordance with the management responsibilities described above. Although there may be no full time trust officer and no active trust committee in the small trust department, the authority and responsibility of these management factors must be exercised by the full board of directors and by its designated active staff member.

Ex 6

FDIC FORM 114 5-1-50

STATEMENT OF PRINCIPLES OF TRUST DEPARTMENT MANAGEMENT

The minimum requirements for sound banking practices in the operation of a Trust Department, and as safeguards for the protection of depositors, fiduciary beneficiaries, creditors, stockholders and the public, should include:

(1) Operation of the Trust Department separate and apart from every other department of the bank, with trust assets separated from other assets owned by the bank and the assets of each trust account separated from the assets of every other trust account; and

(2) Maintenance of a separate set of books and records for the Trust Department in sufficient detail to properly show all Trust Department activities.

The board of directors should, by proper resolution included in its minutes:

(1) Designate an officer, qualified and competent, to be responsible for and administer the activities of the Trust Department, and define his duties;

(2) Name a trust Committee consisting of at least three directors, at least one of whom shall not be an officer of the bank, to be responsible for and supervise the activities of the Trust Department;

The Trust Committee should:

(a) Meet at least once every month;

(b) Review the assets of each trust account at least once during each period of twelve months;

(c) Approve all purchases, sales and changes of trust assets;

(d) Approve the opening of all new trust accounts;

(e) Approve the closing of trust accounts;

(f) Keep full minutes of its actions, including its actions on matters included in (a) through (e) above;

(g) Make periodic reports to the board of its actions.

(3) Provide competent legal counsel to advise the Trust Officers and the Trust Committee on legal matters pertaining to the administration of the Trust Department;

(4) Provide for joint custody of trust assets under at least two or more officers and employees;

(5) Receive the report of the Trust Committee and record its actions thereon in its minutes;

(6) Make or cause to be made an annual audit of the Trust Department at least once during each period of twelve months and, where possible and practical, provide for internal controls over the Trust Department; and

(7) Review the examination reports of the Trust Department by Supervisory Agencies and record its action thereon in its minutes.

Nothing herein is intended to prohibit the board of directors from acting as the Trust Committee, from designating additional officers to administer the operations of the Trust Department and defining their duties, or from appointing additional committees for the Trust Department operation and defining the duties of such committees.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
TRADING AND MARKETS

Ex 7

#7

AUG 5 1968

Mr. Frank M. Kleiler, Director
U. S. Department of Labor
Office of Labor-Management and
Welfare-Pension Reports
8701 Georgia Avenue, Room 801
Silver Spring, Maryland 20910

Re: Notice of Proposed Rule-Making Hearing - Exemption from Bonding Requirements: Investment Advisers; Banks and Trust Companies

Dear Mr. Kleiler:

In response to the Notice of Hearing of the Office of Labor-Management and Welfare-Pension Reports on the above subject set for August 12, 1968, I set forth below at your invitation, a discussion of the Investment Advisers Act of 1940 which you may find pertinent in your consideration of the question whether bonding requirements should be applicable to investment advisers.

If an investment adviser comes within the definition of that term as specified in Section 202(a)(11) of the Investment Advisers Act of 1940 (the Act), he is subject to the anti-fraud provisions of Section 206 of the Act, irrespective of the registration requirements of Section 203(a) of the Act. While in some cases an investment adviser may be engaged in a "transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client" in violation of Section 206(2) of the Act if he operates his business with insufficient financial resources to meet his commitments and obligations to customers, unlike the Securities Exchange Act of 1934 (see Sections 8(b) and 15(c)-(3)), the Investment Advisers Act does not contain specific authorization for the Commission to provide safeguards for clients by prescribing specific financial responsibility requirements for investment advisers. Consequently, no financial responsibility requirements are imposed upon investment advisers as a condition of registration or the operation of their business.

The Act covers a broad spectrum of investment advisory activities, ranging from the publication of periodic material on a subscription basis to the performance of investment supervisory services, namely, the giving of continuous advice to clients as to the investment of funds on the basis of the individual needs of each client.

Mr. Frank M. Kleiler, Director

If an investment adviser has custody or possession of funds or securities of clients, Rule 206(4)-2 under the Act does provide that, unless he is also a registered broker-dealer subject to and in compliance with the net capital rule of the Commission or of a governing national securities exchange, it shall constitute a violation of the anti-fraud provisions of Section 206(4) of the Act if the investment adviser fails to (1) segregate the securities, (2) deposit the funds in an account containing only customers' funds and maintain a separate record for each customer's account specifying details as to deposits and withdrawals, (3) make timely notification to the client of the place and manner in which funds and securities will be maintained, (4) provide each client not less than once every three months with an itemized statement of the client's account at the end of the period and of the activity in the account during the period, and (5) have a surprise audit made by an independent public accountant at least once each year, in the course of which the accountant verifies all of the funds and securities of clients by actual examination. However, this is only an anti-fraud rule, and the investment adviser subject to it is not subject to any general financial responsibility requirements, any more than any other investment adviser, whether registered or not. In any event, the application of such a rule has a very narrow compass, being limited to a very special type of investment adviser.

In view of the above, the Commission would not recommend that registered investment advisers, as a class, be granted an exemption from the bonding requirements of Section 308d(a) of the Welfare and Pension Plan Disclosure Act pursuant to the authority contained in Section 308d(e) of that Act.

Sincerely yours,

Ezra Weiss

Ezra Weiss
Associate Chief Counsel

coverage, then explaining to the Corporate Officer, who generally has had no knowledge of this kind of problem, that it is necessary for us to be insured. We also have done various checking with insurance companies who give conflicting advice depending on what day of the week it is, apparently, because, again, of lack of experience on their part with this very specialized area.

We have a proposal, basically, of the kind of protection that we think would be adequate as far as - - we have no - - if there are members of the Association who do not fit this kind of classification, we would still feel that these conditions should be involved in any exemption. That is, if Investment Counsel has no contact with cash, check, or similar things, has no power to secure physical possession of the cash or other property, has no power to transfer property, other plans to themselves, had no power to disburse funds or other property, had no power to sign or endorse checks, then under those circumstances, where the only power is to purchase a sale or direct the purchase of a sale of securities against the delivery of funds or securities of counter value, and by that I mean the Investment Counsel - - the only power of the Investment Counsel is to direct the Bank to deliver the particular security and receive the cash from the broker or dealer or vice versa. Then, in that instance, the risk of loss from fraud or dishonesty is negligible.

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records of the security transactions on all employees in connection with this in order to see that there isn't a conflict.

This doesn't apply just to Executive Offices but it includes everybody who makes a recommendation or participates in the decision or whose functions relate somehow to the recommendation. It is fairly clear, I would say, that the only risk of loss must be in some sort of a misdirection of investments.

This is an extremely limited possibility. No such case of misdirection has come to our attention.

Now our recommendation is that an exemption be granted for Investment Counsel who are registered with the SEC and who do not take custody of funds or securities and do not have power to acquire possession of the funds or securities.

If the Department feels that the risk involved is negligible and doesn't fit within that section of the Act and that some bonds should be required we would request that it be handled in some method of blanket bonding rather than what turns out to be a very, very expensive bonding requirement of individual bonds for each plan for an Adviser.

For example, according to my conversation with one or another insurance company, the highest rates would be paid in any event. For example, if you had 10 ,$500,000 Bonds, required, and therefore had a single contract for $5,000,000, every increment would be charged at the same amount, the top

Our statement of principles permits our Member Associations to have custody. I don't know if any of our Members have done that. There are special regulations under the Investment Advisers Act concerning custody. Our assumption is in this presentation that if you can't get custody, if you can't get at the securities, then the risk is negligible, and that there is a close policing by the SEC of what you do in terms of the misdirection.

MR. GORDON: I can see the latter point going to the question of whether or not an exemption should be granted by virtue of this regulatory supervision, but as to the first, I am a little bit confused.

We have heard statements made here that there are situations where Banks are in the business of providing investment services without necessarily having custody of the funds.

These institutions are - - they have a bond. They are required to have a bond and the bond covers the performance in this function so that if there is any fraudulent or other dishonest acts with respect to the carrying out of this function resulting in a loss to the particular Welfare Pension Plan involved, the Bank's bond presumably would provide protection.

We have also heard that the supervision exercised by the Banking Authorities would extend to the Fiduciary performance of this obligation, taken on by the Bank as Trustee - - not as Trustee but as investment adviser, in a way.

MR. CASEY: Well, I am not sure I understand exactly your question but first of all, my understanding is bonds for Banks are FDIC bonds. It isn't a Labor Department or special Welfare Disclosure Act bond. Is that correct?

MR. GORDON: A bond required by the FDIC could be obtained by the Bank.

MR. CASEY: Right. And there are some Banks which are not so bonded. Am I correct on that?

MR. MEALY: I think it has been testified to in that regard.

MR. HALE: I am not aware of any of that, or not. But it is theoretically possible some do not have.

MR. CASEY: With that background, I would agree with you, Mr. Gordon, that in this rare instance. It is rare on the part of Banks not to have custody and to have the power to direct the investments that the situation is virtually apparent as far as Investment Counsel are concerned, and if you rely on the FDIC bond in this instance, there should be a method of some sort of reasonable bond required of Investment Counsel.

MR. GORDON: But in fact there is no bond apparently required by the FDIC on Investment Counsel, is there?

MR. CASEY: No.

MR. GORDON: And there is no supervision exercised by the Securities and Exchange Commission with respect to any private bonding arrangements entered into by Investment Counsel

is there?

MR. CASEY: No.

But back to this problem. There is no method by which we could submit our Firms' bonds to the Labor Department for blanket bond for approval in terms of establishing that there is a financial responsibility on our part.

MR. GORDON: Why is that? The scope of this Hearing, as I understand it, is geared to the question of whether or not by virtue of the regulatory supervision exercised by the Securities and Exchange Commission, whether it is unnecessary, by virtue of that supervision, for Investment Counsel to obtain a bond in accordance with the requirement of the Welfare and Pension Plans Disclosure Act.

MR. CASEY: Yes.

MR. GORDON: I assume that without necessarily determining the question, that nothing would preclude a particular Investment Counsel or a class of them from coming in on some other basis and saying they would like an exemption but this Hearing is confined to the question of whether, by virtue, of the supervision exercised by the SEC, they don't need to comply with the Act's bonding requirements. Therefore, what I am trying to ascertain is what aspect is it of regulation by the Securities and Exchange Commission which pertains to whether or not they don't need a bond.

MR. CASEY: We, in terms of Item No. 3, are respond-

how often they are conducted. It is my understanding that the are conducted periodically and also if the Commission receives a complaint as to a particular firm, but just considering the periodic aspect, do you have any figures available on how ofte for instance, within the past five years, a particular Investment Counseling Firm has been instructed by the Commission?

MR. CASEY: Mr. Padegs points out, in the last four years in which it was reported, through June of 1966, they had made over 960 inspections of registered Investment Advisers.

MR. MEALY: Do you know how many firms were involved?

MR. SACKER: How many registered?

MR. HELLER: Mr. Examiner, if I may, I think it's hard to tell how many Investment Adviser Firms are registered because the SEC doesn't keep a current account or, up to recently, has not. There are roughly about 1630, the last time anybody made an account of Investment Advisers. This covers the very broadest spectrum of Investment Advisers , anybody who gives any kind of advice to the Public Bulletin Service, and so on.

The Investment Counsel Group, which is the Investment Supervisory Group, numbers somewhat over 300 - - we would guess around 325 Firms, most of whom are not really, as far as we can tell, engaged in offering their service to the public. It includes people like Boston Trustees, some of the Family Foundations, and so on, who, for their own purposes, meet the

requirements and are registered with the SEC as Investment Counsels. We would guess of firms offering their services to the public, there might be slightly over 100, but that is a guess. We don't have figures of how many members of the Association, have been examined and how often.

From the best figures I have been able to accumulate, I would say every Member has been examined in the last four years and many, more than once.

The examination started about four years ago, so that 960 inspections, or rather the figure Mr. Casey gave you is from the inception of that program to the end of Fiscal year '66. They were making about 250 examinations a year, in the last couple of years.

MR. SACKER: They examined 250 out of about 1600 firms which are designated as Investment Advisers and registered with the Commission, pursuant to the Act.

MR. HELLER: Yes. I think that's fairly accurate.

MR. SACKER: This would imply that there is no assurance that any particular adviser is inspected as often as once a year.

MR. HELLER: I think that's fair to say.

MR. SACKER: As to the requirements under the Commissiods regulations, that there be a surprise annual audit, this requirement is applicable only if the Adviser actually has custody of funds or securities in which the Client has a

one.

MR. CASEY: Yes. Page 18?

MR. SACHER: No. Page 7.

MR. CASEY: Yes.

MR. SACHER: My only question is, this statement, it says "contents of cash, checks or similar property". And Mr. Lawrence just used the word "custody". Custody of funds, securities, or both?

MR. LAWRENCE: Both. We would not - - I am afraid I misled you simply because as far as we are concerned , as investment counsel, confining our business to investment advice, it is so remote that it never occurs to us to say we should not have custody of funds.

You see, we should not have custody of their cash. We shouldn't keep their cash or anything of that sort, because we would never, under any circumstances, have access to that. It would only be conceivable that an investment counsel might have custody of securities of the Plan.

There is nothing in this statute that bars them. There is nothing, indeed, in the Investment Counsel Association's statement of principle and practices which would prevent that.

To t e best of my knowledge, none of the members of the Association have ever followed the practice of having custody. It's a business we don't want to get into.

MR. SACHER: None of the Association members ever have custody of funds or securities?

MR. LAWRENCE: I think that's correct.

MR. KITTREDGE: I can say, as one of the salesmen, that that is correct.

MR. LAWRENCE: We may have included that as a prohibition, if you will, in the statement of principles and practices except for one thing.

Again, competitively, there might arise a time where investment advisers, in order to perform an overall service for their clients, in a way which meets the competition of banks, could adequately be forced in effect to set up their own custody corporations to take custody of something like this and in that case, it would be a whole new ballgame. I mean, we are not asking for anything of that sort.

MR. SACHER: Is there a figure available you could give us as to the number of investment advisers who are registered with the Securities and Exchange Commission, who are giving advice - - and who are giving advice to the employee benefit plans subject to the WPPDA?

MR. LAWRENCE: I don't believe so. I know of no figure of that?

MR. HELLER: I don't think so. I think if you look at the plans' reports, - -

MR. LAWRENCE: You could perhaps make a census. You

exclusively -- for over 37 years. Most of our client relationships have been highly enduring. For example, some months back an internal survey disclosed that almost 44 percent of our clients have retained the company's service for more than 10 years. In fact, one of every six clients has been with us for 25 or more years.

We are unlike banks and, indeed, unlike many other investment counsellors in that we are without potentially prejudicial alliances of any kind. That is, we act only in the capacity of investment advisors and tax consultants for a fee. Unlike banks, we have no trust powers, nor do we take custody of a client's securities or funds. We do not act as brokers or dealers; and unlike the latter, our firm never acts as agent or takes a financial position in securities. We likewise do not serve as underwriters, and we have no connection with a bank or an affiliation with any other financial organization. As an illustration, no mutual fund bears our name. Hence, we have no "show case," so to speak, that could possibly be given consideration ahead of our clients.

We likewise have no special brokers or banks whom we favor. Our clients are generally knowledgeable -- most are leaders in their own communities -- and they are also widespread. I daresay that 90 percent of them are headquartered 500 to 1,000 miles from our New York base. And in

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One: the limited nature and scope of our activities, plus:

Two: our S.E.C. - required self-policing coupled with periodic surveillance of S.E.C. inspections would appear to obviate the need to apply your bonding requirements to a pure investment advisory organization such as ourselves.

What a bank does is almost self-evident. In most instances it provides an enormous variety of services to virtually the entire local population; - services which entail the handling of cash, checks, bearer bonds and other negotiable securities by a great many people employed by each institution. Hence, the FDIC requirement of a bond. But, the scope of an investment advisor's activities is a great deal narrower. It seems almost beyond cavil that for a pure investment counsellor to be guilty of infidelity as respects one of its portfolios, there must be connivance by it, not intramurally, but with one and perhaps several outside entities at least including the broker who actually effects the portfolio transactions, and probably with those administering the particular fund as well.

The safeguards for such a fund are multiple, I think. First, lack of custodianship by the advisor; second, lack of propinquity; third, self-policing; fourth, selectivity

This, again, is scrutiny. How did this come about? Why did it come about? All of this is pervasive in the sense if anyone of us is doing this directly or indirectly, it could be ferreted out and indeed should be ferreted out.

MR. GORDON: You folks have a blanket bond. What's the purpose of having a blanket bond?

MR. MC DADE: I don't follow you. The SEC -- well, simply, I think it is a matter of good business progress. We should have a blanket bond.

MR. HARRISON: May I answer that question? The blanket bond covers not only losses incurred by our clients, but also losses incurred by ourselves from dishonest acts of employees.

MR. GORDON: Have there been any claims under this bond?

MR. HARRISON: None.

MR. GORDON: How many times has Fiduciary Counsel been inspected by the SEC, say within the past five years?

MR. HARRISON: Once, three years ago.

MR. MC DADE: They didn't have power five years ago. The statute did not have power of inspection of investment advisers until 1964 or 5.

MR. GORDON: I see.

MR. ROSE: I would like to clarify one thing, if I may.

MR. MEALY: Speak up, will you?

MR. ROSE: Some of the testimony referred to this morning led me to believe that it is the position of Fiduciary Counsel, Inc. that the power of the Secretary of Labor of the section 13(e) of the Welfare and Pension Plans Disclosure Act was limited to the granting of exemptions on an individual basis and that there is now authority to grant on a cross basis. Is that your position?

MR. SHIPLEY: Well, that seems to be the position of the Court.

MR. GORDON: Mr. Shipley, the Court did not rule on that point.

MR. ROSE: My question is, "Is that what you are contending here this morning?"

MR. SHIPLEY: No. Our position is that Fiduciary Counsel and similarly situated non-custodial investment advisers, registered with the SEC should, of course, be exempt. That's the question posed, by the hearing notice. We believe the Statute does permit the Secretary to have flexibility and we believe banks and trust companies regulated as they are should be exempt as a class, as they are now, under the Rule. We believe you can make a case to meet the criteria of the Statute. That is the risk, the financial responsibility of the Plans. In fact, the risk is so negligible in terms of what we are talking about. The statutory purpose is to

the bank doesn't have custody of the funds or securities.

MR. LACKMAN: I think there is a big distinction. The testimony of Fiduciary Counsel and the ICI, at their last meeting, was to the effect that no investment adviser

Beg 6-1

had custody of the assets. Banks, generally have custody of the assets. What I think I said last time and what I would say today is that there are only a few instances that I know of where the bank did not have custody of the assets, but in those cases the investment work is done by the same people who handle the investment work for those accounts where we do have custody of the assets and the officers' employees are therefore covered under a blanket bond.

MR. HALE: Would it perhaps answer your question to say that there is probably no bank which only gives investment advice, or a trust company which only gives investment advice? Any given bank which normally holds a security may, on any given occasion, give investment advice without holding it, but that's the exception.

MR. SHIPLEY: If I think - - may I interject something, Mr. Gordon, on what Mr. Hale has said?

MR. GORDON: Yes.

MR. SHIPLEY: The investment adviser who is required to be listed on any Federal Securities Laws is only that investment adviser who receives a fee, who sells a service.

DEPARTMENT OF LABOR

Assistant Secretary For Labor-Management Relations

IN THE MATTER OF BONDING EXEMPTIONS FOR FEDERALLY AND STATE-REGULATED BANKS AND INVESTMENT ADVISERS REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION

Section 13(e) of the Welfare and Pension Plans Disclosure Act, hereinafter referred to as WPPDA, 29 U.S.C. 308(e), authorizes the Secretary of Labor to exempt from the bonding requirement of section 13(a), WPPDA, 29 U.S.C. 308d(a), when, in his opinion, it is demonstrated that "financial responsibility" or "other bonding arrangements" would adequately protect the beneficiaries and participants of welfare or pension plans subject to the Act.

On June 26, 1968 and June 29, 1968, notice was published in the Federal Register (33 F.R. 9346, 9556) inviting submission of written and oral communication of data, views or argument on the following issues:

1. Whether banks and trust companies subject to Federal regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria set forth in section 13(e), WPPDA, 29 U.S.C. 308d(e)?

2. Whether banks and trust companies subject to state regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA, 29 U.S.C. 308d(e)?

3. Whether investment advisers registered with and regulated by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940, 15 U.S.C. 80b and subject to 29 CFR Part 464 should as a class

be granted an exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA, 29 U.S.C. 308d(e)?

Details relevant to the background of this rule-making proceeding are found in the Federal Register Notice of June 26, 1968 (33 F.R. 9346) and in Fiduciary Counsel, Inc. v. Wirtz, 383 F.2d 203 (C.A.D.C. 1967). Pursuant to the same notice, hearings on this subject were held on August 12, 1968 and September 20, 1968 before John Mealy, a Hearing Examiner appointed pursuant to 5 U.S.C. 3105 (Supp. II, 1965-66), and the complete record of these proceedings was certified to me on October 15, 1968 for a determination of such amendments to the WPPDA bonding regulations relative to exemptions as are appropriate.

On the basis of the complete record of these proceedings, I have made the following material findings of fact and conclusions.

FINDINGS OF FACT

Banks and Trust Companies Subject to Federal Regulation

1. Banks 1/ which are subject to federal regulation are: (1) national banks which are chartered, regulated and examined by the Comptroller of the Currency, which must, by statute, be members of the Federal Reserve System, and which are automatically insured by the Federal Deposit Insurance Corporation (F.D.I.C.), (2) State chartered banks which apply for and meet the requirements for membership in the Federal Reserve System and which are automatically insured by the F.D.I.C., and, (3) State chartered banks, not members of the Federal Reserve System, which apply to and are accepted by the F.D.I.C. for insurance. 2/

2. All federally regulated banks are required by the F.D.I.C. to purchase fidelity bonding. If a bank refuses to purchase the required bond, the F.D.I.C. is authorized to purchase the bond for it and to add the premium cost thereof to the assessment otherwise payable by the bank for deposit insurance. 3/

3. Bond size in each case is based upon a schedule recommended by the American Bankers Association, modified by the F.D.I.C. according to the particular condition of the bank. 4/

4. In addition to requiring the purchase of bonds, the F.D.I.C. periodically checks the condition of each bank for the purpose, among other things, of making certain that bonding protection remains at the proper level. 5/ All state chartered banks which are not federal reserve members are examined at least once a year by F.D.I.C. examiners. 6/ In the case of national banks and state member banks of the Federal Reserve System, examinations are conducted by the Comptroller of the Currency and the Federal Reserve Banks respectively and the results forwarded to the F.D.I.C. 7/ In addition, reports of condition must be submitted by each federally regulated bank. State chartered non-member banks must submit four reports per year to the F.D.I.C., 8/ which also receives copies of similar reports received by the Comptroller and the Federal Reserve System from banks under their supervision. 9/

Banks and Trust Companies
Subject Only to State Regulation

1. Six states do not require bonding of bank officers and employees. 10/ Of the remaining states, only 24 require approval of bond levels and forms. 11/

2. State minimum capital and reserve requirements vary widely; there is no uniformity. One state has no statutory minimum capital requirements. 12/ Another has no statutory minimum reserve requirements. 13/

3. All states have statutory examination requirements, but the frequency of examinations varies. Two-thirds of the states require examinations annually; twelve states require two per year; one state requires two every eighteen months and in two states the number is left to the discretion of the banking supervisor. 14/ Over 1/2 of the state supervisors reported that their staffs were inadequate for examining purposes. 15/ Only 31 states have statutory requirements for an annual internal audit by or for the bank boards of directors. 16/

Investment Advisers Regulated By the Securities and Exchange Commission

1. The Securities and Exchange Commission (S.E.C.) exercises regulatory functions over investment advisers pursuant to the Investment Advisers Act of 1940. 17/

2. The S.E.C. does not require bonding of investment advisers; no other federal government agency requires bonding. Nor does the S.E.C. or any other federal government agency supervise bond size and form in those cases where a bond has been procured by an investment adviser on its own initiative. 18/

3. The S.E.C. has no minimum capital requirements, nor does it require that any minimum reserve be maintained. It does impose registration and record keeping requirements. 19/

4. Other aspects of S.E.C. regulation which are pertinent to financial responsibility are periodic surprise inspections by the S.E.C. 20/ and the requirement of a surprise annual audit by an independent public accountant where the investment adviser has custody of funds or securities. 21/ However, the surprise inspections by the S.E.C. are infrequent, never as often as once a year and sometimes as seldom as once every three years or more, 22/ and since very few investment advisers have custody of funds or securities, the overwhelming majority are not subject to a surprise examination by a public accountant. 23/

CONCLUSIONS

1. Banks and trust companies subject to Federal regulation should as a class retain their present exemption from the WPPDA bonding requirement since all such institutions are required to maintain bonds the adequacy of which is closely supervised by Federal regulatory authority. By virtue of this supervision, it is concluded that such bonds are "other bonding arrangements" within the contemplation of section 13(e), WPPDA, which provide adequate protection of the beneficiaries and participants of employee benefit plans serviced by these institutions.

2. Banks and trust companies subject to only state regulation should not as a class retain their present exemption

from the WPPDA bonding requirement since not all states require bonding or closely supervise the adequacy of bonding arrangements entered into, because the financial responsibility requirements of states vary too widely to permit a judgment as to their adequacy on a class basis, and because the effectiveness of some state banking supervision is in doubt by reason of a reported inadequacy in staffs. It is concluded that state regulated banks as a class do not, within the contemplation of section 13(e), WPPDA, offer adequate evidence of "financial responsibility" of the plans they service and do not have "other bonding arrangements" which provide adequate protection for the beneficiaries and participants of the plans they service. This conclusion shall not prejudice the right of any state-regulated bank or trust company to petition for a bonding exemption on an individual basis.

3. Investment advisers registered with and regulated by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 and subject to 29 CFR 464 should not as a class be granted an exemption from the WPPDA bonding requirement since the Securities and Exchange Commission does not impose or supervise a bonding requirement with respect to investment advisers, because the Securities and Exchange Commission does not impose or supervise any requirement with respect to investment advisers, pertaining to the maintenance of a sound financial condition, and because the periodic inspections conducted by the Securities and Exchange Commission are not conducted frequently enough to satisfactorily insure the implementation of the fiscal safeguards imposed on investment advisers by law. It is concluded that investment advisers registered with and regulated by the Securities and Exchange Commission as a class do not, within the contemplation of section 13(e), WPPDA, offer adequate evidence of "financial responsibility" of the plans they service and do not have "other bonding arrangements" which provide adequate protection for the beneficiaries and participants of the plans they service. This conclusion shall not prejudice the right of any investment adviser to petition for a bonding exemption on an individual basis.

In view of the foregoing findings of fact and conclusions, I have determined that (1) the existing class exemption from the WPPDA bonding requirement for those banks and trust

companies which are federally regulated shall be continued, (2) the existing class exemption from the WPPDA bonding requirement for those banks and trust companies which are subject only to state regulation shall be revoked, and (3) investment advisers registered with and regulated by the Securities and Exchange Commission shall not be granted an exemption from the WPPDA bonding requirement.

This decision shall be implemented by publication of a notice in the Federal Register proposing appropriate amendments to the WPPDA bonding regulations, 29 CFR 464, 465.

Signed at Washington, D. C. this 11 day of January, 1969.

THOMAS R. DONAHUE
Assistant Secretary of Labor

Footnotes

(All references to "exhibit" or "transcript" refer to documents comprising the record of the Rule-Making Hearing held on August 12 and September 20, 1968)

1. Unless otherwise indicated herein, the word "bank" denotes a commercial bank or trust company.

2. Thus the term "federally regulated," as regards banks, means that one or more of the three federal banking agencies exercises supervision over the bank. At the very least, it means that the bank is insured by the F.D.I.C. and is subject to its regulation. See Exhibit No. 5, letter from William B. Camp, Comptroller of the Currency, Department of the Treasury, page 2; Exhibit No. 6, letter from K. A. Randall, Chairman, Federal Deposit Insurance Corporation, August 7, 1968, page 2; and Exhibit No. 4, Department of Labor submission, pages 6, 18, 27 and 28. Statutory authority for the regulatory functions exercised by the Comptroller of the Currency is found at 12 U.S.C. 21 et seq.; that of the Board of Governors of the Federal Reserve System is at 12 U.S.C. 221 et seq.; and Federal Deposit Insurance Corporation functions are found at 12 U.S.C. 1811 et seq. Federally regulated banks include all but 224 of the nation's 13,741 banks. Exhibit No. 6, page 3.

3. The F.D.I.C. reports that it has had no difficulty persuading banks to purchase bonds and has never had to purchase a bond for a bank. Exhibit No. 6, pages 3-4.

4. "Examiners are given specific instructions with respect to fidelity protection and internal routine and controls. Engagement in trust activities is among the factors which may dictate a need for insurance in amounts higher than those suggested by the American Bankers Association . . . . During the past ten years, special emphasis has been placed by the bank supervisory authorities upon the purchase by banks of excess employee dishonesty coverage, and a majority of the insured commercial banks have now purchased this extra fidelity protection." Exhibit No. 6, page 4. The American Bankers Association recommendations for bonding levels is reproduced in Exhibit No. 28E, American

Bankers Association submission, and in Exhibit No. 4, page 38.

5. Exhibit No. 4, page 37.

6. Exhibit No. 6, page 3.

7. The Comptroller's Office examines National Banks at least three times every two years, and all trust departments are examined annually on a surprise basis. Exhibit No. 5, page 3. State member banks are examined once a year by the Federal Reserve Bank of their district, with separate examination of trust departments by specially trained personnel. Exhibit No. 4, page 25; Exhibit No. 28D-3, 1967 Annual Report of the Board of Governors of the Federal Reserve System, page 318, American Bankers Association submission.

8. Exhibit No. 4, page 35.

9. State member banks must file at least three reports per year with the Federal Reserve bank in their district. Exhibit No. 4, page 23. National banks submit at least three reports per year to the Comptroller. Exhibit No. 4, page 12.

10. California, Delaware, Illinois, Massachusetts, Oregon and Rhode Island. The word "states" includes the Commonwealth of Puerto Rico but not the District of Columbia, the banks of which are federally regulated. Exhibit No. 4, page 48; Exhibit No. 28H-6, American Bankers Association compilation of relevant state statutes.

11. Exhibit No. 4, page 47.

12. Exhibit No. 4A-10, pages 43-44. Ninth Quinquennial Survey, State Bank Division, American Bankers Association, Department of Labor submission. The state is Rhode Island.

13. Id., page 53. The state is Illinois.

14. Id., page 38.

15. Id., pages 29, 29A and 30. Over 1/3 of the Supervisors indicated that the funds available to their departments were not adequate. Id., page 7A.

16. Id., pages 54-55.

17. 15 U.S.C. 80b-1 et seq.

18. Exhibit No. 4, pages 62-63. The scope of regulatory functions performed by the S.E.C. is fully set out at pages 51-59. See also Exhibit No. 7, letter from Ezra Weiss, Associate Chief Counsel, S.E.C., page 1.

19. 15 U.S.C. 80b-3, 17 CFR 275.205-2(a) - (c). But these requirements are only secondarily pertinent to financial responsibility. Their primary purpose is the prevention of securities frauds. An Associate Chief Counsel of the S.E.C. states: . . . unlike the Securities and Exchange Act of 1934, . . . the Investment Advisers Act does not contain specific authorization for the Commission to provide safeguards for clients by prescribing specific financial responsibility requirements for investment advisers. Consequently, no financial responsibility requirements are imposed upon investment advisers as a condition of registration or the operation of their business." Exhibit No. 7, page 1.

20. 15 U.S.C. 80b-4.

21. 17 CFR 275.206(4)-2(a).

22. Exhibit No. 4, page 59, Transcript of Hearing, page 121.

23. Exhibit No. 7, page 2, Transcript, pages 37, 39, 42, 67, 80, 83 and 129.

March 10, 1969

Mr. Carl L. Shipley
Shipley, Ackerman & Pickett
1204 National Press Building
Washington, D.C. 20004

SOL: 64-(WP)-12

Re: Bonding Exemption for Fiduciary Counsel, Inc. Under the Welfare and Pension Plans Disclosure Act

Dear Mr. Shipley:

On August 15, 1967, you formally requested on behalf of your client, Fiduciary Counsel, Inc., New York, New York, that this Office reconsider its decision denying an exemption from the Welfare and Pension Plans Disclosure Act bonding requirement to Fiduciary Counsel, Inc. You were advised by the Secretary of Labor in a letter dated September 21, 1967 that the matter was being reviewed in light of the decision of the United States Court of Appeals for the District of Columbia in Fiduciary Counsel, Inc. v. Wirtz.

Subsequently, it was decided, with your concurrence, to hold the litigation in abeyance while administrative proceedings were conducted for the purpose of reexamining the regulations pertaining to class bonding exemptions. As you know, formal Rule-Making hearings were held, written and oral comments were received, and proposed changes to the regulations were published in the Federal Register on January 23, 1969 (34 FR 1051). Among other things, the effect of the notice was to deny a class bonding exemption to investment advisers. Objections to the proposed changes presented no facts or argument not previously considered and the proposed changes will be shortly finalized by publication in the Federal Register.

In light of the foregoing, we are taking this opportunity to inform you that we reaffirm our prior determination concerning the petition for exemption from Fiduciary Counsel, Inc. and hereby deny the petition for exemption.

Sincerely yours,

/s/ Frank H. Kleiler

Frank M. Kleiler
Director

SOL: S.J. Sacher:
kre:3/6/69
ANB 807, Ext. 4073

Affidavit of W. J. Usery, Jr.

My name is W. J. Usery, Jr. I am Assistant Secretary of Labor for Labor-Management Relations. Pursuant to an order of the Secretary of Labor (Secretary's Order 16-68, September 4, 1968), I have been delegated the authority and responsibility to issue rules and regulations under the Welfare and Pension Plans Disclosure Act (WPPDA) of 1958, as amended. (Secretary's Order 16-68, paragraph 4a(3), 4b(10), Exhibit A).

Upon remand of the case of Fiduciary Counsel, Inc. v. Wirtz to the United States District Court for the District of Columbia, it was decided that administrative proceedings should be held by the Office of Labor-Management and Welfare-Pension Reports, United States Department of Labor, for the purpose of ascertaining and documenting facts pertinent to the issue of whether the denial of the petition of Fiduciary Counsel, Inc. for a exemption from the bonding requirement of the Welfare and Pension Plans Disclosure Act (WPPDA) was an arbitrary decision. Therefore, an administrative hearing, including oral proceedings on August 12 and September 20, 1968, was held to determine:

1. Whether banks and trust companies subject to Federal regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria set forth in section 13(e), WPPDA?

2. Whether banks and trust companies subject only

to state regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA?

3. Whether investment advisers registered with and regulated by the Securities and Exchange Commission (SEC) pursuant to the Investment Advisers Act of 1940, and subject to 29 CFR Part 464 should as a class be granted an exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA?

All interested parties, including Fiduciary Counsel, Inc., were given notice and opportunity to present written and oral views and arguments. At the conclusion of the hearings the entire record was certified to my prececessor, Assistant Secretary of Labor for Labor-Management Relations Thomas R. Donahue, for decision. On the record of the hearing, which is attached to this affidavit and incorporated herein by reference, then Assistant Secretary Donahue decided that the previously existing class exemption for banks and trust companies subject to federal regulation should be retained, that the previously existing class exemption for banks and trust companies subject only to state regulation should be revoked, and that the proposed class exemption for investment advisers regulated by the Securities and Exchange Commission (SEC) should not be granted. Since the petition of Fiduciary Counsel, Inc. for an individual exemption was based solely upon the degree of regulation exercised over it by the SEC and thus presented for consideration no ground other than that upon which the proposed class exemp-

tion for investment advisers had been based, that petition was denied. I have reviewed the record and former Assistant Secretary Donahue's findings and I concur in his decisions.

After notice which proposed new regulations reflecting these decisions and requested comments, the new regulations were published in final form in the Federal Register on March 13, 1969. I believe that the evidence adduced in the hearing supports the Secretary's refusal to grant an exemption from the WPPDA bonding requirement to Fiduciary Counsel, Inc.

Signed in Washington, this ___ day of April, 1969.

/s/ W. J. Usery, Jr.
W. J. Usery, Jr.
Assistant Secretary of Labor
For Labor-Management Relations

IN THE UNITED STATES DISTRICT COURT

FOR THE

DISTRICT OF COLUMBIA

FIDUCIARY COUNSEL, INC.,
Plaintiff,

v.

GEORGE P. SHULTZ,
Secretary of Labor,
United States Department
of Labor,
Defendant.

CIVIL ACTION NO. 2665-63

ORDER

This cause having come on for hearing upon defendant's motion for summary judgment and on plaintiff's cross motion for summary judgment, and the Court having considered the motions of the parties, the points and authorities in support thereof and in opposition thereto, and the record of the administrative hearing incorporated therein, and having heard oral argument, and it appearing that there is no genuine issue as to any material fact and that the defendant is entitled to summary judgment as a matter of law, it is by the Court this 19th day of January, 1970,

ORDERED that plaintiff's cross motion for summary judgment be, and the same is, hereby denied.

ORDERED that defendant's motion for summary judgment be, and the same is, hereby granted.

ORDERED that judgment is entered in favor of defendant against plaintiff, and the action be, and the same is, hereby dismissed.

United States District Judge

No. 23,987

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

FIDUCIARY COUNSEL, INC.,

Appellant,

v.

JAMES D. HODGSON,
SECRETARY OF LABOR,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE APPELLEE

WILLIAM D. RUCKELSHAUS,
Assistant Attorney General,

THOMAS A. FLANNERY,
United States Attorney,

MORTON HOLLANDER,
DONALD L. HOROWITZ,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

I N D E X

CITATIONS

Legislative History:

Miscellaneous:

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*Authorities principally relied upon are marked with an asterisk.

IN THE UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 23,987

FIDUCIARY COUNSEL, INC.,

Appellant,

v.

JAMES D. HODGSON,
SECRETARY OF LABOR,

Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED*

After the remand on the earlier appeal of this case, the Secretary conducted a comprehensive investigation into the subject of exemptions from the bonding requirements of

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*This case has previously been before this Court. Fiduciary Counsel, Inc. v. Wirtz, 127 U.S. App. D.C. 276, 383 F. 2d 203 (1967). That opinion is reproduced in the Supplemental Appendix to appellant's brief, SA 1-7. After the decision of this Court, appellant petitioned for certiorari, which was denied. 389 U.S. 1005 (1967). That order appears at SA 8.

the Welfare and Pension Plans Disclosure Act. The evidence showed that the safeguards applicable to registered investment advisers were far weaker than those applicable to federally-regulated banks and hence did not warrant a class exemption for investment advisers. The sole question presented by this appeal is whether this decision of the Secretary, based on the abundant evidence contained in the comprehensive administrative record, is arbitrary, capricious or unreasonable.

STATUTE AND REGULATIONS INVOLVED

Section 13(a) and (e) of the Welfare and Pension Plans Disclosure Act, 29 U.S.C. §§ 308d(a) and (e), provide as follows:

> (a) Every administrator, officer, and employee of any employee welfare benefit plan or of any employee pension benefit plan subject to this chapter who handles funds or other property of such plan shall be bonded as herein provided; except that, where such plan is one under which the only assets from which benefits are paid are the general assets of a union or of an employer, the administrator, officers and employees of such plan shall be exempt from the bonding requirements of this section. The amount of such bond shall be fixed at the beginning of each calendar, policy, or other fiscal year, as the case may be, which constitutes the reporting year of such plan. Such amount shall be not less than 10 per centum of the amount of funds handled, determined as herein provided, except that any such bond shall be in at least the amount of $1,000 and no such bond shall be required in an amount in excess of $500,000: Provided, That the Secretary, after due notice and opportunity for hearing to all interested parties, and after consideration of the record, may prescribe an amount in excess of $500,000, which in no event shall exceed 10 per centum of the funds handled. For purposes of fixing the amount of such bond, the amount of funds handled shall be determined by the funds handled by the person, group, or class to be covered by such bond and by their predecessor

or predecessors, if any, during the preceding reporting year, or if the plan has no preceding reporting year, the amount of funds to be handled during the current reporting year by such person, group, or class, estimated as provided in regulations of the Secretary. Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of such administrator, officer, or employee, directly or through connivance with others. Any bond shall have as surety thereon a corporate surety company which is an acceptable surety on Federal bonds under authority granted by the Secretary of the Treasury pursuant to sections 6-13 of Title 6. Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule or blanket forms of bonds which cover a group or class.

* * *

Regulations; exemption of plan

(e) The Secretary shall from time to time issue such regulations as may be necessary to carry out the provisions of this section. When, in the opinion of the Secretary, the administrator of a plan offers adequate evidence of the financial responsibility of the plan, or that other bonding arrangements would provide adequate protection of the beneficiaries and participants, he may exempt such plan from the requirements of this section.

The amended regulations promulgated under the Act, 29 C.F.R. §§ 465.19 and 465.20, provide as follows:

§ 465.19 Exemption.

An exemption from the bonding requirements of subsections 13(a) and (b) of the Welfare and Pension Plans Disclosure Act is granted whereby banking institutions and trust companies specified in § 465.20 are not required to comply with subsections 13(a) and (b) of the Act, with respect to welfare and pension benefit plans covered by the Act.

§ 465.20 Conditions of exemption.

This exemption applies only to those banking institutions and trust companies subject to regulation and examination by the Comptroller of the

Currency or the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation.

COUNTERSTATEMENT OF THE CASE

Fiduciary Counsel, Inc., is a registered investment adviser with power to issue binding investment directions to the trustees of the employee pension trust established by the Parker Pen Company. Fiduciary seeks an exemption from the bonding requirements of the Welfare and Pension Plans Disclosure Act, 29 U.S.C. §§ 301 et seq. (hereinafter cited as WPPDA). The Secretary of Labor has denied the exemption, the district court has sustained the Secretary's action, and Fiduciary has taken this appeal.

This is the second time this case has been before this Court. See Fiduciary Counsel, Inc. v. Wirtz, 127 U.S. App. D.C. 276, 383 F. 2d 203 (1967), cert. denied, 389 U.S. 1005 (1967). The previous appeal involved two questions: (1) whether Fiduciary, as an investment adviser, is subject to the Welfare and Pension Plans Disclosure Act; and (2) if Fiduciary is subject to the Act, whether it was entitled to an exemption from the bonding requirements of the Act, 29 U.S.C. § 308d(e).

The district court had concluded that Fiduciary is covered by the statute, and this Court affirmed that conclusion. The district court, however, had not addressed itself to Fiduciary's claim of exemption, This Court remanded for a determination of the reasonableness of the Secretary's action in exempting banks that are subject to federal or state regulation but not

exempting registered investment advisers.

This Court noted that banks which were subject to either federal or state supervision or examination were exempted from the bonding requirements of the Act, notwithstanding that the nature and quality of that supervision varied widely. Some states, for example, did not require bonding, while others did not subject their banks to periodic examination. Investment advisers, on the other hand, were required to register with the Securities and Exchange Commission. Although registration with the SEC entails certain safeguards against fraudulent dealing--in particular, the requirements of full disclosure, reporting and record-keeping and the criminal penalties for fraud--investment advisers were not exempted by the Secretary of Labor from the requirement of a bond. Comparing the wide variations in state banking regulation with the registration requirements of the SEC, the Court found a possibility

> that the employees of Parker Pen Company are in no greater danger of having their pension assets diminished by reason of the dishonest investment advice emanating from appellant than they would be if this advice were supplied by a state bank which is either not bonded at all or in an amount less than that required by the Act, or which is not examined at all or only in a perfunctory manner.

127 U.S. App. D.C. at 279, 383 F. 2d at 206.

Fiduciary competes with banks, including state-regulated banks, for investment counseling business. The requirement that Fiduciary post a bond while banks need not do so, no matter how haphazardly they might be regulated, thus raised serious questions about the reasonableness of the exemptions

granted by the Secretary. The Court, therefore, remanded the case to the district court for a determination of "the reasonableness of appellee's action in exempting the banks but not appellant." 127 U.S. App. D.C. at 279, 383 F. 2d at 206.

After this decision, Fiduciary petitioned for certiorari, attacking the determination that it was covered by the Welfare and Pension Plans Disclosure Act. Certiorari was denied. 389 U.S. 1005 (1967).

The decision of this Court prompted the Secretary to reevaluate the regulatory provisions for exemptions from the bonding requirements. The Secretary announced his intention to hold hearings on this subject, and moved for a stay of proceedings in the district court, pending the outcome of the hearings. The stay was granted, and the Secretary published a Notice of Proposed Rule Making in the Federal Register. 33 Fed. Reg. 9346, 9556 (June 26, 29, 1968), reproduced at SA 9-10.[1/] Written and oral communications, views and argument were invited from interested parties on the following questions:

> 1. Whether banks and trust companies subject to Federal regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria set forth in section 13(e), WPPDA, 29 U.S.C. 308d(e)?
>
> 2. Whether banks and trust companies subject to State regulation should as a class retain their present exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA, 29 U.S.C. 308d(e)?

1/ "SA" refers to the Supplemental Appendix which accompanies the Brief for the Appellant on the instant appeal.

3. Whether investment advisers registered with and regulated by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940, 15 U.S.C. 80b and subject to 29 CFR Part 464 should as a class be granted an exemption from the WPPDA bonding requirement in light of the criteria in section 13(e), WPPDA, 29 U.S.C. 308d(e)?

Hearings were held. Written submissions from many interested financial institutions, their clients and professional associations were received, considered and incorporated in the record. In addition, testimony was taken; among the active participants in the hearing were both Fiduciary Counsel and the Investment Counsel Association of America, Inc.

The evidence adduced at the rule-making hearing showed the Court's apprehensions about the unevenness of state regulation of banks to be well-founded. The Department of Labor had conducted an exhaustive study of federal and state supervision of banks and trust companies, as well as federal supervision of investment advisers. The study was received in evidence at the hearing (Ex. 4, App. 63[2/]). The study confirmed that wide variations exist in bonding requirements (Ex. 4, pp. 47-48, App. 47-48). Six states do not require bonding of bank officers and employees. Of these, two require a deposit of securities with a state authority when the bank engages in the conduct of trust business. The remaining four require no such deposit as a uniform condition of engaging in

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2/ "Ex." refers to exhibits received in evidence at the rule-making hearing. "App." refers to the Appendix which accompanies this brief. On Motion of appellee, leave was granted by this Court on June 9, 1970, to file such an Appendix.

the trust business. Of those states that authorize or require fidelity bonding, only three require the state banking authority to fix the amount of the bond. Twenty-one states require the bank to arrange for bonding, subject to the approval of the state banking authority; there is no evidence of the stringency or laxity of the standards governing approval. The statutes of eight states authorize but do not require the state banking authority to require bonding. In thirteen states the bank is bound to procure a bond, but there is no requirement that the bond be approved by any state authority (Ex. 4, pp. 47-48, App. 47-48).

In addition to exemptions based on adequate bonding arrangements, the WPPDA authorizes the granting of exemptions based on evidence of "financial responsibility." 29 U.S.C. § 308d(e). If state regulation provided some assurance of financial responsibility, a class exemption for state-regulated banks might be justified on that ground. The evidence, however, indicated that, while nearly every state imposed minimum capital and reserve requirements for banks and trust companies, here, too, the standards were highly variable. Capital requirements varied with the population of the city, as well as the state, in which the bank was located (Ex. 4, p. 46, App. 46). Reserve requirements varied from 7 to 30 per cent for demand deposits and from 3 to 20 per cent for time and savings deposits (Ex. 4, p. 46, App. 46). Qualitative differences also existed in the types of assets required to comprise reserves. See Hackley, <u>Our Baffling Banking System</u>,

52 Va. L. Rev. 565, 569 (1966).

Despite these disparities, some assurance of "financial responsibility" might be provided if stringent state regulatory controls were present. But the evidence on this point, too, disclosed anything but uniformity. All states have statutory requirements of regular bank examinations at least once a year; a few require more than one a year (Ex. 4, p. 45, App. 45). All states require reports on demand at irregular intervals, as well as regular annual reports (Ex. 4, p. 45, App. 45). Similarly, all states have the authority to correct unsound banking practices, and many (though not all) require an internal audit (Ex. 4, p. 46, App. 46). The problem in this respect is not that the formal requirements are generally deficient, but rather that enforcement is frequently inadequate. In a "Profile of State-Chartered Banking," prepared by the National Association of Supervisors of State Banks in 1967, most state banking supervisors stated that their staffs were inadequate, and fully half of the supervisors stated that they were unable to meet even the state statutory requirement of an annual bank inspection. These responses accorded with a voluminous study done by the American Bankers Association (Ex. 4A-10), the results of which are summarized in the Department of Labor submission to the hearing examiner (Ex. 4, pp. 43-45, App. 43-45). The inadequacy of state financial supervision was summarized by Archie K. Davis, President of the American Bankers Association, in 1966:

> . . . while some states have supervisory departments which are the equal in quality to the federal agencies, too many other states are failing in this regard. Very roughly, one might estimate that bank regulation is significantly below standard in probably a third of our states. The causes are varied, but most can be traced to the failure of state legislatures and the respective banking communities to recognize the importance of adequate supervision of banks at the state level.
>
> * * *
>
> . . . in many of our states . . . banking department personnel are underpaid and relatively untrained, and . . . supervisory budgets are inadequate.

Davis, Banking Regulation Today: A Banker's View, 31 Law and Contemporary Problems 639, 643 (1966). Thus, while in most cases state statutes were not notably deficient, state enforcement mechanisms were of dubious efficacy at best.

On the basis of the evidence concerning state regulation, the Secretary concluded:

> Banks and trust companies subject to only State regulation should not as a class retain their present exemption from the WPPDA bonding requirement since not all States require bonding or closely supervise the adequacy of bonding arrangements entered into, because the financial responsibility requirements of States vary too widely to permit a judgment as to their adequacy on a class basis, and because the effectiveness of some State banking supervision is in doubt by reason of a reported inadequacy in examining staffs. It is concluded that State regulated banks as a class do not, within the contemplation of section 13(e), WPPDA, offer adequate evidence of "financial responsibility" of the plans they service and do not have "other bonding arrangements" which provide adequate protection for the beneficiaries and participants of the plans they service. This conclusion shall not prejudice the right of any State regulated bank or trust company to petition for a bonding exemption on an individual basis.

34 Fed. Reg. 1051 (Jan. 23, 1969), SA 11, App. 115-116. 3/

This left the question of whether federally-regulated

3/ The evidence underlying these conclusions was summarized in the following Findings of Fact, made by the Secretary:

Banks and Trust Companies
Subject Only to State Regulation

1. Six states do not require bonding of bank officers and employees. */ Of the remaining states, only 24 require approval of bond levels and forms. **/

2. State minimum capital and reserve requirements vary widely; there is no uniformity. One state has no statutory minimum capital requirements. ***/ Another has no statutory minimum reserve requirements. +/

3. All states have statutory examination requirements, but the frequency of examinations varies. Two-thirds of the states require examinations annually; twelve states require two per year; one state requires two every eighteen months and in two states the number is left to the discretion of the banking supervisor. ++/ Over 1/2 of the state supervisors reported that their staffs were inadequate for examining purposes. +++/ Only 31 states have statutory requirements for an annual internal audit by or for the bank boards of directors. §/

App. 114.

[The following footnotes are contained in the Secretary's Findings of Fact:]

*/ California, Delaware, Illinois, Massachusetts, Oregon and Rhode Island. The word "states" includes the Commonwealth of Puerto Rico but not the District of Columbia, the banks of which are federally regulated. Exhibit No. 4, page 48; Exhibit No. 28H-6, American Bankers Association compilation of relevant state statutes.

**/ Exhibit No. 4, page 47.

[Continued]

banks and registered investment advisers should receive exemptions from the bonding requirements of the Act. The Secretary found that the evidence warranted an exemption for federally-regulated banks but did not warrant a similar exemption for investment advisers.

These two types of institutions are subject to two completely different sets of controls. The evidence adduced at the hearing showed that the standards and safeguards imposed on investment advisers diverged considerably from those imposed on federally-regulated banks. The great majority of banks across the country are regulated by one or more of the three federal agencies and hence insured by the F.D.I.C. 4/

3/ [Footnotes contained in the Secretary's Findings of Fact (Continued):]

***/ Exhibit No. 4A-10, pages 43-44. Ninth Quinquennial Survey, State Bank Division, American Bankers Association, Department of Labor submission. The state is Rhode Island.

+/ Id., page 53. The state is Illinois.

++/ Id., page 38.

+++/ Id., pages 29, 29A and 30. Over 1/3 of the Supervisors indicated that the funds available to their departments were not adequate. Id., page 7A.

§/ Id., pages 54-55.

4/ In the category of "federally-regulated banks," the Secretary included:

(1) national banks which are chartered, regulated and examined by the Comptroller of the Currency, which must, by statute, be members of the Federal [Continued]

The F.D.I.C. requires all of its member-banks to procure fidelity bonding. If an insured bank refuses to comply with such a requirement, the F.D.I.C. is authorized to purchase the insurance and add the cost thereof to the assessment payable by the bank to the F.D.I.C. Deposit insurance. 12 U.S.C. § 1828(e). (The F.D.I.C. has never had to resort to this technique (Ex. 6, p. 4, App. 12).) Adequacy of bonding is determined by following the schedule recommended by the American Bankers Association (see Ex. 4, p. 38, App. 38). Trust activity, in the F.D.I.C.'s view, may dictate a need for greater protection that the Bankers Association schedule recommends. "During the past ten years," according to the F.D.I.C. submission to the rule-making hearing, "special emphasis has been placed by the bank supervisory authorities upon the purchase by banks of excess employee dishonesty coverage, and a majority of the insured commercial banks have now purchased this extra fidelity protection" (Ex. 6, p. 4, App. 72).

Because all three types of federally-regulated banks are insured with the F.D.I.C., all federally-regulated banks carry

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4/ [Continued]

Reserve System, and which are automatically insured by the Federal Deposit Insurance Corporation (F.D.I.C.), (2) State chartered banks which apply for and meet the requirements for membership in the Federal Reserve System and which are automatically insured by the F.D.I.C., and, (3) State chartered banks, not members of the Federal Reserve System, which apply to and are accepted by the F.D.I.C. for insurance. At the very least, therefore, a "federally-regulated bank" is insured by the F.D.I.C. and is subject to its regulation. See Ex. 4, pp. 6, 18, 27-28, Ex. 5, Ex. 6.

bonds which meet both the amounts recommended by the Bankers Association and the standards of supervision imposed by the F.D.I.C. itself. See generally Ex. 6, App. 69-95.

The Department of Labor submission to the hearing examiner detailed the precise nature of the supervision of regulated banks by the three agencies charged with this function: the F.D.I.C., the Comptroller of the Currency and the Federal Reserve System. See Ex. 4, pp. 5-41, App. 5-41. (No contradictory evidence was introduced at the hearing.) In addition to bonding, the supervision extends to financing, reporting and examining. All federally-regulated banks must meet uniform minimum capital requirements and maintain specified reserves. Federal agencies have power to grant or deny bank charters on the ground of unsound management or personnel or inadequate capital or future earning prospects. All federally-regulated banks must submit reports of condition at least three times per year. All are examined at surprise intervals at least three times every two years. Specially trained persons examine trust departments in great detail. See the attachment to Ex. 6, App. 73-94. Deficiencies must be corrected, or pain of loss of charter. See generally Ex. 4, pp. 5-41, App. 5-41.

Because of this detailed oversight by the federal banking agencies, the Secretary concluded that federally-regulated banks and trust companies should retain their exemption from the bonding requirements of the WPPDA, concluding that the bonds required by the federal regulatory authorities are "'other

bonding arrangements' within the contemplation of section 13(e), WPPDA, which provide adequate protection of the beneficiaries and participants of employee benefit plans serviced by these institutions." 34 Fed. Reg. 1051 (Jan. 23, 1969), SA 11, App. 115.[5/]

5/ The Secretary based his conclusion on the following Findings of Fact:

> 2. All federally regulated banks are required by the F.D.I.C. to purchase fidelity bonding. If a bank refuses to purchase the required bond, the F.D.I.C. is authorized to purchase the bond for it and to add the premium cost thereof to the assessment otherwise payable by the bank for deposit insurance. */
>
> 3. Bond size in each case is based upon a schedule recommended by the American Bankers Association, modified by the F.D.I.C. according to the particular condition of the bank.**/
>
> 4. In addition to requiring the purchase of bonds, the F.D.I.C. periodically checks the condition of each bank for the purpose, among other things, of making certain that bonding protection remains at the proper level.***/ All state chartered banks which are not federal reserve members are examined at least once a year by F.D.I.C. examiners. +/ In the case of national banks and state member banks of the Federal Reserve System, examinations are conducted by the Comptroller of the Currency and the Federal Reserve Banks respectively and the results forwarded to the F.D.I.C.++/ In addition, reports of condition must be submitted

[Continued]

These bonding requirements, financial safeguards and rigorous supervision contrasted sharply with the regulation to which investment advisers are subject. To begin with, the evidence showed that, although some investment advisers voluntarily maintain fidelity bonds, there is no requirement that they do so or, if they choose to do so, that the bond

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5/ [Continued]

by each federally regulated bank. State chartered non-member banks must submit four reports per year to the F.D.I.C.,+++/ which also receives copies of similar reports received by the Comptroller and the Federal Reserve System from banks under their supervision. §/

App. 113-114.

[The following footnotes are contained in the Secretary's Findings of Fact:]

*/ The F.D.I.C. reports that it has had no difficulty persuading banks to purchase bonds and has never had to purchase a bond for a bank. Exhibit No. 6, pages 3-4.

**/ "Examiners are given specific instructions with respect to fidelity protection and internal routine and controls. Engagement in trust activities is among the factors which may dictate a need for insurance in amounts higher than those suggested by the American Bankers Association . . . . During the past ten years, special emphasis has been placed by the bank supervisory authorities upon the purchase by banks of excess employee dishonesty coverage, and a majority of the insured commercial banks have now purchased this extra fidelity protection." Exhibit No. 6, page 4. The American Bankers Association recommendations for bonding levels is reproduced in Exhibit No. 38E, American

[Continued]

be adequate (Tr. 44-45, App. 101-102; Ex. 4, p. 62, App. 62). Further, while investment advisers must register with the SEC, the SEC has no power to impose minimum capital or reserve requirements on an investment adviser or otherwise to insure that the adviser maintains a sound financial condition (Ex. 4, pp. 51-59, App. 51-59; Ex. 7, App. 96-97).

5/ [Footnotes contained in the Secretary's Findings of Fact (Continued):]

Bankers Association submission, and in Exhibit No. 4, page 38.

***/ Exhibit No. 4, page 37.

+/ Exhibit No. 6, page 3.

++/ The Comptroller's Office examines National Banks at least three times every two years, and all trust departments are examined annually on a surprise basis. Exhibit No. 5, page 3. State member banks are examined once a year by the Federal Reserve Bank of their district, with separate examination of trust departments by specially trained personnel. Exhibit No. 4, page 25; Exhibit No. 28D-3, 1967 Annual Report of the Board of Governors of the Federal Reserve System, page 318, American Bankers Association submission.

+++/ Exhibit No. 4, page 35.

§/ State member banks must file at least three reports per year with the Federal Reserve bank in their district. Exhibit No. 4, page 23. National banks submit at least three reports per year to the Comptroller. Exhibit No. 4, page 12.

At the hearing, an exemption was demanded for investment advisers on the basis of their registration with the SEC. In its submission to the hearing examiner, however, the SEC stated that "the Commission would not recommend that registered investment advisers, as a class, be granted an exemption from the bonding requirements of Section 308d(a) of the Welfare and Pension Plan Disclosure Act pursuant to the authority contained in Section 308d(e) of that Act" (Ex. 7, p. 2, App. 97).

The letter from the SEC reviewed the protection provided by the Investment Advisers Act of 1940. It noted that while an investment adviser is subject to the anti-fraud provisions of that Act, "no financial responsibility requirements are imposed upon investment advisers as a condition of registration or the operation of their business" (Ex. 7, p. 1, App. 96). Certain safeguards against fraud are imposed, the letter continued, if the investment adviser "has custody or possession of funds or securities of clients" (Ex. 7, p. 2, App. 97). However, since most investment advisers do not take custody of a client's funds or securities (Tr. 37, 39, 42, 67-68, 80, 83, 129; App. 98-100, 105-107), 6/ this anti-fraud protection, in the words of the SEC,

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6/ See especially Tr. 68, App. 106:

> MR. SACHER: None of the Association members ever have custody of funds or securities?
>
> MR. LAWRENCE: I think that's correct.
>
> MR. KITTREDGE: I can say, as one of the salesmen, that that is correct.

"has a very narrow compass, being limited to a very special type of investment adviser" (Ex. 7, p. 2, App. 97). Hence, the Commission did not believe that investment advisers should receive a bonding exemption.

Much the same is true of the fiscal safeguards imposed by the SEC. An annual surprise examination is required only in the rare cases where the investment adviser has custody of a client's funds or securities. 17 C.F.R. 275.206(4)-2(a). Although the SEC is authorized to conduct periodic inspections of investment advisers, 15 U.S.C. § 80b-4, these inspections are infrequent. The evidence at the hearing was that about 250 inspections had been made annually, although some 1600 investment advisers are registered with the Commission (Tr. 47-48, App. 103-104). During the year ending March 31, 1967, the SEC had inspected only 122 of the 552 investment advisers in the New York area, and 28 of the 334 advisers in San Francisco (Ex. 4, p. 59, n. 187; App. 59 n. 187). Hence there was no assurance of an annual or even a biennial or triennial inspection by the SEC. Fiduciary Counsel testified that it had been inspected once in the past three years (Tr. 121, App. 109).

Recognizing the disparities between the safeguards imposed on federally-regulated banks and those imposed on registered investment advisers, the Secretary determined that investment advisers should not receive a class exemption:

> 3. Investment advisers registered with and regulated by the Securities and Exchange Commission pursuant to the Investment Advisers Act of 1940 and subject to 29 CFR 464 should not as a class be granted an exemption from the WPPDA bonding requirement since the Securities and Exchange Commission

does not impose or supervise a bonding requirement with respect to investment advisers, because the Securities and Exchange Commission does not impose or supervise any requirement with respect to investment advisers, pertaining to the maintenance of a sound financial condition, and because the periodic inspections conducted by the Securities and Exchange Commission are not conducted frequently enough to satisfactorily insure the implementation of the fiscal safeguards imposed on investment advisers by law. It is concluded that investment advisers registered with and regulated by the Securities and Exchange Commission as a class do not, within the contemplation of section 13(e), WPPDA, offer adequate evidence of "financial responsibility" of the plans they service and do not have "other bonding arrangements" which provide adequate protection for the beneficiaries and participants of the plans they service. This conclusion shall not prejudice the right of any investment adviser to petition for a bonding exemption on an individual basis.

34 Fed. Reg. 1051-52, SA 11-12, App. 116. 7/

7/ The Secretary's conclusion was based on the following Findings of Fact:

Investment Advisers Regulated
By the Securities and Exchange Commission

1. The Securities and Exchange Commission (S.E.C.) exercises regulatory functions over investment advisers pursuant to the Investment Advisers Act of 1940. */

2. The S.E.C. does not require bonding of investment advisers; no other federal government agency requires bonding. Nor does the S.E.C. or any other federal government agency supervise bond size and form in those cases where a bond has been procured by an investment adviser on its own initiative. **/

[Continued]

[The following footnotes are contained in the Secretary's Findings of Fact:]

*/ 15 U.S.C. 80b-1 et seq.

**/ Exhibit No. 4, pages 62-63. The scope of regulatory functions performed by the S.E.C. is fully set out at pages 51-59. See also Exhibit No. 7, letter from Ezra Weiss, Associate Chief Counsel, S.E.C., page 1.

[Continued]

The outcome of the administrative proceedings, therefore, was the revocation of the bonding exemption for state-regulated

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7/ [Continued]:

3. The S.E.C. has no minimum capital requirements, nor does it require that any minimum reserve be maintained. It does impose registration and record keeping requirements. ***/

4. Other aspects of S.E.C. regulation which are pertinent to financial responsibility are periodic surprise inspections by the S.E.C. +/ and the requirement of a surprise annual audit by an independent public accountant where the investment adviser has custody of funds or securities. ++/ However, the surprise inspections by the S.E.C. are infrequent, never as often as once a year and sometimes as seldom as once every three years or more, +++/ and since very few investment advisers have custody of funds or securities, the overwhelming majority are not subject to a surprise examination by a public accountant. §/

App. 115.

[Footnotes contained in the Secretary's Findings of Fact continued:]

***/ 15 U.S.C. 80b-3, 17 CFR 275.205-2(a) - (c). But these requirements are only secondarily pertinent to financial responsibility. Their primary purpose is the prevention of securities frauds. An Associate Chief Counsel of the S.E.C. states: . . . unlike the Securities and Exchange Act of 1934, . . . the Investment Advisers Act does not contain specific authorization for the Commission to provide safeguards for clients by prescribing specific financial responsibility requirements for investment advisers. Consequently, no financial responsibility requirements are imposed upon investment advisers as a condition of registration or the operation of their business. Exhibit No. 7, page 1.

+/ 15 U.S.C. 80b-4.

++/ 17 CFR 275.206(4)-2(a).

+++/ Exhibit No. 4, page 59, Transcript of Hearing, page 121.

§/ Exhibit No. 7, page 2, Transcript, pages 37, 39, 42, 67, 80, 83 and 129.

banks, the reaffirmation of the exemption for federally regulated banks, and the denial of an exemption for investment advisers. After the promulgation of the Secretary's new conclusions and the amendment of the regulations pursuant thereto, cross-motions for summary judgment based on the administrative record were filed in the district court. By order dated January 19, 1970, the district court denied Fiduciary's motion and granted the Secretary's motion for summary judgment (App. 125).

ARGUMENT

I

THE SECRETARY IS AUTHORIZED TO GRANT CLASS EXEMPTIONS.

At the outset, it is appropriate to dispose of appellant's suggestion that the Secretary may not grant any class exemptions. The legislative history conclusively refutes that suggestion. The Senate Report, S. Rep. No. 908, Sept. 8, 1961, explains that "the Secretary may grant exemptions from the bonding requirements in the case of any person for whom <u>other bonding arrangements required by Federal or State law</u> are in his opinion adequate for the protection of plan beneficiaries and participants . . ." (emphasis supplied). Obviously, federal and state law require bonding arrangements in certain classes of classes, and it follows that where the Secretary finds such arrangements adequate he may grant an exemption for that class. The Conference Report, No. 1417, House, March 12, 1962, in 1962 U.S. Code Cong. & Admin. News 1552, 1553, is even more explicit:

> The conference substitute adopts the provisions of the House bill, with the additional provision that

> the plan could be exempted from the bonding requirements, not only when the administrator offers adequate evidence of financial responsibility but also when he is of the opinion that other bonding arrangements would provide adequate protection for the participants and beneficiaries: That intent is that the Secretary of Labor will, by regulation or by a case-by-case procedure, be empowered to accept other forms of surety to protect welfare and pension funds.

(Emphasis supplied.) In the face of this unequivocally expressed intention, appellant's argument that Congress did not contemplate class exemptions is utterly devoid of merit.[8/]

The only basis on which appellant has ever sought exemption is on a class basis. The essence of his contention is that investment advisers, as a class, ought to come within the embrace of the exempting regulation. This contention can hardly be squared with appellant's present suggestion that class exemptions are unauthorized.

8/ Moreover, this contention was expressly waived by counsel for Fiduciary at the rule-making hearing. The question was asked whether Fiduciary contended that the Act limited the Secretary's power to the granting of exemptions on an individual rather than a class basis. The reply was as follows:

> MR. SHIPLEY: No. Our position is that Fiduciary Counsel and similarly situated non-custodial investment advisers, registered with the SEC should, of course, be exempt. That's the question posed, by the hearing notice. We believe the Statute does permit the Secretary to have flexibility and we believe banks and trust companies regulated as they are should be exempt as a class, as they are now, under the Rule.

Tr. 122, App. 110.

It would seem to require little argument to demonstrate that class exemptions, where justified by the nature of the regulation of the class, eliminate the duplicative processing of essentially identical exemption applications based solely on the character of the applicable class regulation. There are, after all, more than 13,000 federally-regulated banks (Ex. 6, p. 3, App. 71). If, in the Secretary's view, by virtue of the uniform regulation imposed on them, all of these meet the standards to qualify for exemption, Congress surely cannot be deemed to have intended the Secretary to go through the ritual of passing on each application separately. By promulgating his new regulation, the Secretary has done exactly what Congress contemplated. In the case of federally-regulated banks, he has granted an exemption "by regulation . . . ." Conf. Rept. No. 1417, supra, at 1553. In the case of all other institutions, the Secretary has decided that eligibility for exemption will be determined "by a case-by-case procedure . . . ." Id.[9/] The only question, therefore,

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9/ Appellant is incorrect in stating that "The Secretary has taken the position that he should not grant exemptions by acting separately on individual petitions." Brief, p. 9. The Secretary has in fact taken the very opposite position. He stated that the denial of a class exemption to investment advisers "shall not prejudice the right of any investment adviser to petition for a bonding exemption on an individual basis." See p. 20 , supra. The effect of the Secretary's determination that state-regulated banks and registered investment advisers were not entitled to class exemptions was to put them on a case-by-case footing. It should be emphasized, however, that Fiduciary has only requested an exemption from the Secretary on the basis of its regulation by the SEC; that is, it has only requested an exemption for the class of which it is a member. It has never requested an individual exemption based on a showing of protection greater than that afforded merely by virtue of registration by the SEC.

is whether the Secretary's classification of the institutions that are entitled to class exemptions is reasonable--a question to which we now turn.

II

THE AMENDED REGULATION IS NOT UNREASONABLE AND THE DISTRICT COURT'S REFUSAL TO UPSET IT SHOULD THEREFORE BE SUSTAINED.

The sole question here is whether the amended regulation promulgated by the Secretary is arbitrary, capricious or unreasonable. See Nebbia v. New York, 291 U.S. 502 (1934). As the Supreme Court has recently reemphasized, the judiciary has only the most limited role to play in the regulation of economic institutions. Dandridge v. Williams, 397 U.S. 471, 484-85 (1970). Where classifications and exemptions are concerned, judicial review is available only if they embody an "invidious discrimination." Ferguson v. Skrupa, 372 U.S. 726, 732 (1963); Williamson v. Lee Optical Co., 348 U.S. 483, 489 (1955).

Nothing approaching that is present here. In its earlier opinion in this case, the Court stated that the Secretary of Labor's regulations, as then drafted, had placed banks "outside the statute without reference to whether the character of the regulation applicable to a particular bank comports with either of the statutory standards by which Congress has said that the exemption of a particular plan is to be measured." 127 U.S. App. D.C. at 279, 383 F. 2d at 206, SA 6. That statement no longer reflects the contours of the regulation. The Secretary has received impressive evidence that all federally-regulated banks, by virtue of the regulatory requirements imposed on them,

do meet the statutory standards for exemptions. He has likewise received evidence that state-regulated banks do not uniformly meet those standards, and has accordingly denied them, as well as investment advisers, a class exemption.

We have recounted the evidence on which the Secretary acted in our Counterstatement of the Case, <u>supra</u> pp. 7-20 . The basic differences between federally-regulated banks and registered investment advisers are these:

1. The F.D.I.C. requires all member banks to procure fidelity bonding in amounts determined according to asset strength and other financial indicia. It oversees fulfillment of this requirement and often recommends excess coverage. <u>No bonding requirement whatever is imposed on investment advisers by the SEC</u>. See <u>supra</u>, pp. 13-14, 16, 20 n. 7.

2. All federally-regulated banks are required to meet uniform capital and reserve requirements. The appropriate federal agencies undertake to oversee the banks they regulate to insure that they maintain high standards of financial soundness. <u>No such oversight for financial responsibility is undertaken by the SEC for investment advisers, and the SEC has explicitly recommended to the Secretary of Labor that no bonding exemption be granted investment advisers on this ground</u>. See <u>supra</u>, pp. 14, 17-20.

3. Federally-regulated banks are examined frequently by a corps of trained examiners. Trust departments receive special attention. <u>The SEC inspections of investment advisers are less comprehensive and much less frequent</u>. See <u>supra</u>, pp. 14, 18-20.

We submit that this formidable evidence was more than ample to warrant the Secretary's conclusion that federally-regulated banks are sufficiently protected against the risk of loss by virtue of bonds, the adequacy of which is closely supervised by federal regulatory authorities. These differences in regulation give short shrift to appellant's contention that it "is no different from federally-regulated banks . . . ." Brief, p. 11.

Fiduciary makes essentially two arguments against the reasonableness of the Secretary's determination. First, Fiduciary contends that the exemptions granted to federally-regulated banks are not based on bonding arrangements that meet the statutory standard of ten per cent of the amount of funds handled. Second, Fiduciary suggests that, because investment advisers generally do not have custody of the trust assets, the risk of loss from dishonesty on their part is so reduced as to warrant a bonding exemption. There is no merit in either of these arguments.

The fallacy in the ten per cent argument is readily exposed. Section 13(a) of the WPPDA, 29 U.S.C. § 308d(a), provides that when a bond is required under the Act the amount of the bond shall be not less than ten per cent of the amount of the funds handled. There is, however, no comparable ten per cent requirement for an exemption under section 13(e), 29 U.S.C. § 308d(e).

The sole criterion under section 13(e) is that there be, "in the opinion of the Secretary," adequate evidence either of the financial responsibility of the plan or that "other bonding arrangements would provide adequate protection of the beneficiaries and participants . . . ." 29 U.S.C. § 308d(e). There is nothing in subsection (e) that requires a bond to meet the ten per cent requirement of subsection (a); if it did, there would be no need for an exemption. Although, of course, the amount of the bond is a relevant consideration, the Secretary may also take into account the nature of the bonding supervision. In the case of federally-regulated banks, he has been convinced that the periodic review of bank bonding arrangements that is conducted by federal officials constitutes an assurance that banks will procure and maintain bonding in amounts appropriate to the risk that these closely-regulated institutions pose. There is ample evidence to support the reasonableness of that judgment.

At the rule-making hearing, investment advisers, including Fiduciary, repeatedly argued that if an investment adviser "has no contact with cash, check, or similar things," then "the risk of loss from fraud or dishonesty is negligible" (Tr. 37, App. 98). That contention is reiterated here. Despite this argument, however, it was conceded that a risk of loss did remain "in some sort of misdirection of investments" (Tr. 39, App. 99).

Undoubtedly, the risk of loss is diminished when custody is not obtained. But that does not mean that the risk of loss is "negligible." On the contrary, the Secretary could reasonably have found the risk to be substantial. Even in the absence of

custody, there remain multiple opportunities for wrongdoing. An investment adviser may engage in outright self-dealing; he may counsel or direct the purchase or sale of a security in which he has an interest. He may channel the investments of his clients in a particular direction for a consideration. He may prefer one client over another by recommending that the non-preferred client trade in securities recommended to the preferred client, in order to drive the price up. His investment advisory functions may conflict with the performance of other functions he may assume, and his direction of investments may suffer from this conflict of interest.

Fiduciary's answer is to point to the SEC's elaborate pattern of protective regulation against self-dealing of all kinds. But the SEC, as we have seen, imposes neither bonding nor financial responsibility requirements on investment advisers. Congress attempted to assure that, by virtue of a bond or the sheer weight of an institution's assets, any loss resulting from a breach of fiduciary duty will be repaired. It therefore required evidence of adequate bonding or financial responsibility to protect the beneficiaries. Fiduciary Counsel argues that investment advisers should gain an exemption based on neither. That argument was properly rejected by Congress, by the Secretary and by the court below. It should also be rejected by this Court.[10/]

10/ In view of this Court's earlier opinion in this case, and in view of the Supreme Court's denial of appellant's petition for certiorari (SA 8), appellant's argument that it is not covered by the Act is plainly frivolous. In view of the district court's consideration of the extensive administrative record--all [Continued]

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed.

Respectfully submitted,

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August 1970

CERTIFICATE OF SERVICE

I hereby certify that on this ~~14~~ 17th day of August, 1970, I served the foregoing Brief for the Appellee upon counsel for the appellant by mailing copies thereof, postage prepaid, to:

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of which went to the reasonableness of the Secretary's determination --appellant's argument that the district court did not address itself to the question of reasonableness merits no reply.

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